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FINAL OVERSIGHT HEARINGS ON THE SAVINGS AND LOAN INDUSTRY IN THE 100th CONGRESS

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

ESTIMATES ON THE SIZE OF THE THRIFT PROBLEMS, WHAT WENT WRONG? WHAT SHOULD BE DONE? SHOULD THE SIZEABLE LOSSES BE PAID BY THE INDUSTRY OR THE TAXPAYER? INFORMATION THAT WILL BE NEEDED FOR THE NEXT ADMINISTRATION AND CONGRESS TO ACT DECISIVELY TO PLACE THE INDUSTRY AND ITS REGULATORY SYSTEM ON A SOUNDER FOOTING

AUGUST 2 AND 3, 1988

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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FINAL OVERSIGHT HEARINGS ON THE SAVINGS AND LOAN INDUSTRY IN THE 100TH CONGRESS

TUESDAY, AUGUST 2, 1988

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10:15 a.m., in room SD-538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Dixon, Sasser, Sanford, Graham, Garn, Heinz, Hecht, Bond, and Chafee.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The Chairman. The committee will come to order.

This morning the committee begins a 2-day oversight hearing on the condition of the savings and loan industry.

Our panel consists of three distinguished savings and loan executives and Under Secretary of the Treasury Gould. Tomorrow we will hear from the past three chairmen of the Federal Home Loan Bank Board.

We've asked each witness to focus on three questions. First, what is the size of the thrift problem? Second, what went wrong? Third, what should be done? We've already received widely varying estimates on the size of the problem, but whatever the correct number is, it is obvious that the next administration and the next Congress will need to act quickly and decisively to place the industry and its regulatory system on a sounder footing.

Before we can come to a consensus on what should be done, we need to have a realistic understanding of how we got where we are. Therefore, I believe the main value of these hearings is to help this committee understand the origins of the thrift problem and what led to the sizable losses now before us.

Whether these losses should be paid by the industry or the taxpayer will be debated next year, but whatever the outcome of that debate, we need major structural reforms to assure that the thrift crisis will not be repeated. And we cannot agree on structural reforms unless we can reach a common understanding of what went wrong with our present system.

Holding oversight hearings on the problem of the thrift industry presents this committee with something of a dilemma. Exaggerated headlines about the condition of the industry could help undermine the public confidence necessary for the industry's orderly recovery. At the same time the Congress and the next administration will presumably be faced with some extremely difficult decisions on what to do about the thrift problem. Those decisions cannot be made intelligently without a deeper understanding of the problem, without understanding the truth, however unpleasant that truth may be.

If we are to err, I would rather err on the side of too much information rather than too little. I have confidence that the financial press will be able to report this issue with accuracy and understanding. I am equally confident that the public understands that the Federal Government stands fully behind its deposit insurance program. I can't repeat that too often. We've said that repeatedly. We've affirmed it on the floor. I know of no Senator or Congressman who doesn't agree that we will fulfill that and that all insured deposits are as good as gold.

Accordingly, I look forward to the insights our witnesses will be able to provide the committee over the next 2 days.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator **Garn**. Thank you, Mr. Chairman.

Today we begin still another set of hearings on the problems of the thrift industry. I fully realize that Congress must keep a close eye on these problems, but at some point hearings and sensational publicity could prove to be counterproductive. I urge my colleagues to bear that in mind as we close in on the last 30 legislative days of this Congress.

Today's hearing certainly could prove to be lively since the testimony shows some differences of opinion between Secretary Gould on the one hand and industry representatives on the other.

Before I give my opening comments, I would like to acknowledge for the record that this may be the last time Secretary Gould will testify before this committee in his current capacity. I want to thank you, Mr. Secretary, for the fine job you've done. Not everyone here may have agreed with all of your positions over the past 2 years, but you've always been very forthright with your views and very cooperative with this committee. I just wish we had taken your advice in 1986 and passed FSLIC recap as we tried so hard to do at the end of the 99th Congress.

Let me also add one thing that your testimony is not quite right about. October 1986, the Senate did pass a clean FSLIC recap. It didn't bounce back and forth. The House wanted to add a gigantic housing authorization bill and that's why in October 1986 FSLIC recap died. The Senate did pass a clean FSLIC recap at that time.

Today you gentlemen will testify about the reasons for the FSLIC problem and what we ought to do about it. About the only thing you seem to agree on is that neither the industry nor the taxpayers want to pay for it. Let me tell you right here that I am with the taxpayers, as you all know. We should do everything we can to avoid taxpayer bailouts.

Mr. Gould, I'm sure you will have plenty to say about the history of the FSLIC recap plan and where we would be now if that plan had passed 2 years ago, but the industry testimony seems to avoid that question. It talks instead about how Congress bungled the situation by phasing out interest rate controls when Senator Proxmire was chairman, then made matters worse when I was chairman by engaging in competition of laxity of regulation with State legislatures when we passed Garn-St Germain.

Gentlemen, to be very candid about it, I think these claims are outrageous. If we hadn't taken interest rate controls off deposits, your industry would have gone to hell in a handbasket. Money market funds were eating your lunch. Most of the industry was in here begging, saying we've got sweep accounts, they are uninsured, and we're competing with 16 or 17 percent interest rates of money market funds, and those deposit flows in excess of $300 billion were flowing out of traditional depository institutions. Most of your industry was in here begging for some way to be able to compete with the new boys on the block. That's why I say I think it's outrageous to come back and tell us now where you were. The record is very clear about who wanted interest rate controls and who was asking to have them removed.

Likewise, to equate what Garn-St Germain did with a few States with real estate powers for State-chartered thrifts is ludicrous. We gave a very modest amount of new powers to a much smaller number of Federal thrifts and it simply has not been a serious part of the FSLIC problem. I would suggest that people start looking at numbers and looking at the institutions that have been in the news the last few months particularly. They are State-chartered institutions given powers that go far beyond what any Federal law has given them. So go yell at State legislatures about being lax.

And I suggest the record, once again, proves that what powers were granted here have not been a significant part of the problem.

What I find really interesting is the industry breast-beating. Your testimony paints such a rosy picture of the industry constantly urging Congress and the regulators for restraint, greater regulatory controls, and tougher accounting standards, but nobody would listen. Who's kidding who? Who was it that sought at every turn to delay the passage and the amount of FSLIC recap? Who said it was only a $5 billion problem to the House of Representatives in passing CEBA? The record again is clear. The industry was constantly talking about $5 billion recap and opposing mine and Senator Proxmire's $15 billion of FSLIC recap in 1986.

Perhaps worst of all, who supported the onerous forbearance restrictions in the House just 1 year ago? The message your industry was giving us 1 year ago was loud and clear—don't close us down. Forbearance was supposed to give you the breathing room to turn your problems around and get the regulators off your backs and lighten up on the accounting standards.

I sat in that conference day after day with industry representatives talking to my staff and passing notes up trying to have forbearance. And now every day somebody is saying, "Why didn't they close those institutions down? Why wasn't FSLIC closing them down?"

Damn it, gentlemen, your industry was over in that conference begging for ridiculous forbearance provisions to keep them open. I'm not talking about you gentlemen personally. Please don't misunderstand me. But I am talking about your industry and I'm talking about fact and anybody who observed that conference knows what I'm talking about. You jumped all over because I wasn't in favor of those forbearance provisions and some of us were saying these institutions should not be carried and we should not lighten up on regulatory standards. That's a matter of record.

So to read your testimony today that you've been browbeating Congress and we haven't acted, when the actions of your industry are just the opposite and have been for some period of time. So let's stop playing games. There have obviously been big problems in the industry caused by a variety of factors. The interest rate mismatch, the oil and agricultural problems, poorly staffed regulators, excessive State deregulation, and our delay in passing the FSLIC recap, and just plain old fraud and mismanagement.

So I will not sit back and let the industry either the healthy or the sick thrifts wash its hands of it. Your official positions at times have been very much a part of the problem as I have outlined. Yes, we need to urge the regulators to adopt and maintain policies that will lessen FSLIC's problems. Your testimony makes some good suggestions that merit our serious consideration. Yes, we cannot afford to devastate the healthy thrifts in order to pay for the sick ones. But your industry cannot simply rush to dump all of its problems on the American taxpayer, and the tactic of constantly speculating about how big the problem is won't get you there any faster. You've all made a great deal of money hanging out the FSLIC sign over your door, special assessments or not, and that is something to keep in mind. I certainly will as you testify today.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

Senator Riegle.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Thank you, Mr. Chairman.

I have a statement that I will make a part of the record and would just summarize briefly two or three thoughts.

We have a major disaster on our hands in the savings and loan system and no matter how it's described that's the bottom line. The best estimates we have indicate that the deficiency right now is somewhere between $50 and $100 billion.

Now that's an extraordinary amount of money. There was a fellow over at the AID agency that was caught in a fraudulent situation the other day who stole in effect $1.5 million of Federal money. We read about defense contractors cheating here or there to the tune of several million dollars. This is a figure that's probably close to $75 billion that's gone, that's disappeared, that's going to have to be replaced by one means or another. We're going to have to come up with the money to replace those losses. So we have an enormous problem. It's unprecedented.

Nothing like it has happened in all the years that the Federal Government has been in operation. So it's entirely appropriate, Mr. Chairman, that you have these hearings to try to figure out how this happened and how we can stop it from getting worse. The best estimates that I've seen indicate that our losses are mounting probably at the rate of about a billion dollars a month, and so not only do we have this enormous exposure now, but we're going to have an even larger problem at the time when we have a new team in place that's willing to hit this thing head-on. So it's essential that we get the facts on the table. We've got witnesses today who are competent to help us understand that. There are different points of view. It's appropriate that they all be laid on the table. We have to get the facts known, and I don't think anybody ought to feel defensive about anything. I think what we're talking about here is a question of how we stop the hemorrhaging that is going on. We must get this industry back on a solid footing.

[The complete prepared statement of Senator Riegle follows:]

OPENING STATEMENT OF SENATOR DONALD W. RIEGLE, JR.
AUGUST 2, 1988 - 10:00 a.m.

Mr. Chairman. Whether the next President of the United States is Governor Dukakis or Vice President Bush, the number one financial services priority of the new Administration must be addressing the problems of the Federal Savings and Loan Insurance Corporation. Some people say the FSLIC problem will resolve itself, they are wrong. My best judgement is that we have a $50 to $100 billion problem here. It will have a major budgetary impact regardless of how it is handled.

I commend you Mr. Chairman for conducting an in-depth analysis of this problem now. We must establish a hearing record to determine the mistakes made by the regulators, the industry, the Congress and the Administration--Republican and Democrat alike. A top priority for the short term must be to stop the current hemorrhage at FSLIC. That drain is estimated at some $1 billion a month - it may be higher.

Some people would prefer that we not continue our public analysis of these problems until next year. I see no reason for that. Congress stands 100 percent behind deposits insured by FSLIC. That said, it is time to move forward to determine first, how we got into this situation; second, what regulatory and structural changes should be made at the Federal Home Loan Bank Board to ensure that these problems do not arise in the future; third, how we stop the current drain of funds from FSLIC; fourth, how we determine the likely cost of handling the problem; and fifth, how we go about paying the outstanding bill.

The least we can do as a result of these hearings is to begin to lay the foundation so that the next Administration and

Congress can address these issues promptly in 1989. These hearings should also assist the National Commission on the Thrift Industry which Senators Sasser and Graham have advocated and whose creation I support.

In the short term I believe the following suggestions should be considered immediately by the regulators.

1. The Federal Home Loan Bank Board should adopt and enforce a program for stopping the growth of deposits and other secured borrowing at insolvent FSLIC insured savings and loan associations as measured by generally accepted accounting principles.

2. Capital standards should be raised over time for savings and loan institutions from 3% to anywhere between 5% to 8%.

3. I am concerned that there may be developing another interest-rate-mismatch problem in the industry. The Federal Home Loan Bank Board should review this issue and ensure that, where appropriate, institutions take actions to reduce interest rate risk.

4. Constraints should be placed upon the approval of acquisitions by weak companies of insolvent companies. One possible recommendation would be that no FSLIC-assisted acquisition will be approved unless the resulting company has at least a 3% GAAP net worth position.

5. To the extent feasible, action should be taken to prevent weak institutions from paying above-market rates just to keep the doors open.

6. Federal deposit insurance should be used to safeguard federally authorized activities--additional activities authorized by states should be protected by separate supplemental insurance

provided by the states. The federal taxpayer cannot be put on the hook for insuring additional business activities authorized by the individual states. And,

7. The Federal Home Loan Bank Board must immediately set up a Task Force to investigate all loans at insolvent institutions so that we can get from them a much more accurate assessment of the dollar value of the problem that we face. It is incomprehensible to me that this was not done some time ago. The Bank Board's examination force must also be upgraded, and supplemented to the extent possible, by examination professionals from the other bank regulatory agencies.

I am sure that our witnesses over the next 2 days will want to comment on these and offer their own suggestions. I hope that all recommendations resulting from these hearings will be taken seriously by the regulators in the time remaining on their watch. And, Mr. Chairman, I look forward to your continued leadership on these issues throughout the remainder of your distinguished Chairmanship.

Finally, I want to commend our private sector witnesses for appearing today. It takes courage for those who are regulated to appear before Congress and comment about their regulators and regulation. I can assure you that your testimony today -- whatever it may be -- is most welcome and we will see to it that whatever you say in good faith has no adverse consequences for you at the FHLBB.

The CHAIRMAN. Thank you, Senator Riegle.
Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, about a year ago the President signed CEBA, the Competitive Equality Banking Act, which called for a $10.8 billion recapitalization plan to replenish the FSLIC insurance fund. Since that time the industry, as we have all come to recognize, has suffered growing losses. Those continuing losses have taken a heavy toll on the FSLIC. The FSLIC recently doubled its estimate of the cost to implement the Southwest plan to $15 billion, and the total price tag is almost $31 billion.

Estimates by others pale in comparison and go upward of $70 to $90 billion. At this point I am not aware of anybody who knows what the facts are, but the range of estimates does suggest that we have many sick thrifts that are not dead, but in serious, critical or even dying condition. From day to day their health varies with changes in interest rates, real estate prices and cash flow. Some of their healthy relatives in the industry contend that their sick cousins are brain dead and are kept alive by artificial life support in the form of deposit insurance. Healthy thrifts, in general, want to pull the plug and save the cost of prolonged hospitalization and intensive care. They estimate that each day of continued life costs them millions of dollars in the form of FSLIC insurance premiums.

However, the sick thrifts say they are too young to die. With proper treatment in the form of capital forbearance and daily infusions of fresh deposits, they believe they can be cured. The sick thrifts contend they have a severe case of depression—economic depression, but all they need is a rise in oil prices to boost their spirits and their balance sheets.

Mr. Chairman, during the course of these hearings, we will no doubt retrace the steps leading up to this financial condition. However, the $64 billion question is not how did we get here, but where do we go from here? It seems to me that for the near term the FSLIC must act swiftly to stem the bleeding in the industry. In the process it must avoid exacerbating losses by flooding real estate markets with assets acquired through liquidation. In the longer term, we must examine the structure of an insurance program which has proven to be both costly and unreliable and at the same time take a very hard look at the impact of financial institution deregulation on the future of the thrift industry.

Mr. Chairman, the FSLIC itself is in a serious condition and despite a dose of heavy medicine just a year ago I have concerns about its prognosis. It has a full house. Almost all available beds in the hospital's intensive care unit are full. There is a lineup waiting outside the emergency room and the insurers and billpayers are having second thoughts about stepping up to the plate.

We can ill afford to wait for a miracle cure. The treatment needs to be administered carefully, but nonetheless decisively to avoid unintended side effects. If we set a realistic course of recovery—and I emphasize the word realistic—it will be easier to swallow the bitter medicine.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Dixon.

Senator Dixon. I will place my statement in the record, Mr. Chairman.

The Chairman. Thank you, Senator Dixon. I also have statements from Senators Cranston, Sasser, D'Amato, and Chafee.

[Committee insert of Senator Dixon's statement:]

Alan J Dixon

AUGUST 2, 1988

STATEMENT OF SENATOR ALAN DIXON

SENATE BANKING COMMITTEE HEARING
ON
THE THRIFT INDUSTRY

MR. CHAIRMAN, I AM PLEASED TO BE HERE THIS MORNING AS THE COMMITTEE CONTINUES ITS OVERSIGHT HEARINGS ON THE PROBLEMS FACING THE THRIFT INDUSTRY. IT SEEMS INCREASINGLY CLEAR THAT FURTHER LEGISLATION TO ADDRESS THE INDUSTRY'S PROBLEMS, AND THE PROBLEMS FACING THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION, WILL BE NEEDED. WHILE NO LEGISLATIVE CONSENSUS HAS YET EMERGED, THESE HEARINGS WILL HELP PROVIDE THE BACKGROUND INFORMATION THIS COMMITTEE NEEDS AS IT CONSIDERS THE DIFFICULT AND EXTRAORDINARILY COMPLICATED ISSUES INVOLVED. WE HAVE AN EXPERT GROUP OF WITNESSES BEFORE US THIS MORNING, AND I LOOK FORWARD TO HEARING THEIR TESTIMONY.

I WILL NOT TAKE THE TIME OF THE COMMITTEE THIS MORNING TO MAKE A LENGTHY STATEMENT. I DO, HOWEVER, WANT TO MAKE ONE POINT THAT I HAVE MADE BEFORE: NO ONE SHOULD ALLOW THIS NECESSARY EXAMINATION OF THE VERY SERIOUS PROBLEMS FACING THE S&L INDUSTRY AND FSLIC TO OBSCURE THE FUNDAMENTAL FACT THAT THE FEDERAL GOVERNMENT STANDS BEHIND FSLIC. NO DEPOSITORS AT ANY OF OUR NATION'S THRIFTS NEED HAVE ANY CONCERN ABOUT THEIR ACCOUNTS UP TO THE FULL INSURED LEVEL.

OPENING STATEMENT OF SENATOR ALAN CRANSTON
HEARINGS ON THE CONDITION OF THE THRIFT INDUSTRY
AUGUST 2ND AND 3RD, 1988 - 10:00 A. M.

I AM PLEASE TO BE HERE THIS MORNING AS THE SENATE BANKING COMMITTEE EXAMINES THE CAUSES OF THE THRIFT PROBLEMS AND POSSIBLE SHORT AND LONG RANGE OPTIONS THAT MAY BE AVAILABLE TO ASSIST THE CONGRESS IN RESOLVING THE PRESENT DIFFICULTIES IN THIS INDUSTRY.

THIS IS A TOUGH TIME FOR OUR DEPOSITORY INSTITUTIONS. THERE ARE SOME 500 OR SO THRIFTS ON THE INSOLVENT LIST, A RECORD NUMBER. BANKS ARE FAILING AT A RATE OF 150 PER YEAR. HOWEVER, THE THRIFT INDUSTRY PROBLEMS ARE SIGNIFICANTLY WORSE. EVEN IN THE FACE OF THESE ADVERSE CONDITIONS, THE PUBLIC STILL DEMONSTRATES ITS CONFIDENCE IN THIS SYSTEM BY KEEPING THEIR FUNDS IN THRIFT INSTITUTIONS. WE HAVE A RESPONSIBILITY TO PRESERVE THE THRIFT INDUSTRY'S ROLE AS THE PRINCIPAL LEADER FOR HOUSING IN OUR NATION. BY DEVISING A MUCH NEEDED LONG TERM PLAN FOR RECOVERY OF THE THRIFT INDUSTRY, WE WILL BE ABLE TO PRESERVE THIS SYSTEM AND PROTECT THE OVERWHELMING MAJORITY OF THRIFTS THAT ARE CONTINUING TO SERVE OUR NATION WELL IN SPITE OF THE SERIOUSNESS OF THE PROBLEMS FACING THEIR INDUSTRY.

I LOOK FORWARD TO HEARING THE SUGGESTIONS OF THE DISTINQUISHED PANEL OF FORMER REGULATORS.

STATEMENT OF SENATOR JIM SASSER, SENATE BANKING COMMITTEE, AUGUST 2, 1988

MR. CHAIRMAN, THANK YOU FOR SCHEDULING THESE HEARINGS ON THE PRESSING AND CRITICALLY IMPORTANT ISSUE OF THE CONDITION OF THE THRIFT INDUSTRY AND THE FSLIC.

THE CONDITION OF THE THRIFT INDUSTRY IS GOING TO BE THE MOST IMPORTANT QUESTION BEFORE THE COMMITTEE WHEN WE RETURN NEXT YEAR. ANYTHING WE CAN DO NOW TO GET A HEAD START WILL BE VERY HELPFUL.

INDEED, I AM HOPEFUL THAT WE WILL BE ABLE TO BRING THE COMMISSION BILL INTRODUCED BY SENATOR GRAHAM AND I TO THE FLOOR IN THE VERY NEAR FUTURE, HOPEFULLY NEXT WEEK. WE NEED AN EVALUATION AND INVESTIGATION BY A GROUP OF IMPARTIAL EXPERTS. WE NEED TO HAVE THEIR RECOMMENDATIONS EARLY IN THE YEAR, SO THAT WE CAN PROCEED QUICKLY ON A BANKING BILL.

LASTLY, MR. CHAIRMAN, I WANT TO SAY THAT THE TESTIMONY OF THE SECOND PANEL TODAY -- THE THRIFT INDUSTRY EXECUTIVES -- IS

EXCELLENT. IT GIVES US A GOOD IDEA OF HOW WE GOT TO WHERE WE ARE, AND WHERE WE SHOULD GO FROM HERE.

I AGREE WITH MUCH OF IT. IT WILL BE HELPFUL TO THE COMMITTEE. THANK YOU AGAIN FOR CALLING THESE HEARINGS. I LOOK FORWARD TO THE DAY'S TESTIMONY.

STATEMENT OF SENATOR D'AMATO
AUGUST 2, 1988

I look forward to hearing the testimony of today's distinguished panel on the condition of the thrift industry. By now after many, many months of close study and some small efforts at a solution we are to a point of consensus on the root causes of the thrift industry crisis. We also understand, that the problem will not be solved unless this government acts in a coherent and forceful way.

Since the extensive hearings which were held in May on this subject, we in this committee have taken a small but important step toward improving the capital strength of the thrift industry. I take this opportunity to thank and commend the many co-sponsors of our Freddie Mac legislation. However, as we count our small steps in the right direction, we must recognize that we are a long way from a comprehensive solution to the thrift industry problem. Even this relatively simple matter of allowing the free market in securities to operate in a way that improves the capital structure of thrifts is proving complex because of -- at least impart -- continued restriction on its free sale and purchase.

Moreover, the clearest signal from all sectors -- indeed, the irrefutable truth -- is that the thrift problem grows larger by the day. Another clear signal is that the problem is not yet beyond our powers to correct. On the positive side we should recognize that the thrift industry has many strong institutions ably represented here today by Mr. Levy, Mr. Sandler and Mr. Shackelford. These healthy institutions can survive and provide a strong nucleus for the post-crisis thrift industry provided we do not delay too long in taking action. However, if we delay while insolvent institutions increase the losses at FSLIC, drive up the cost of funds for all institutions and sap the management resources of the Bank Board we grow closer to the point at which insolvent institutions become increasing burdens, the condition of the industry goes from serious to critical and healthy S & Ls-- good businesses -- are dragged down with the bad businesses.

These hearings, with testimony from the managers of healthy institutions, give us the opportunity to see this problem as more than a matter of money. As we consider the thrift problem we need to consider more than how much money and where will it come from. We need to consider the cost of further delay, not just in terms of dollars, but also in terms of the decline and potential fall of good thrift institutions.

SPEECH BY
SENATOR JOHN H. CHAFEE
TO
SENATE BANKING COMMITTEE
ON THE THRIFT INDUSTRY
(AUGUST 2, 1988)

MR. CHAIRMAN. THE HEARINGS TODAY AND TOMORROW ON THE THRIFT INDUSTRY ARE CRITICAL TO LAY THE GROUNDWORK FOR SUBSTANTIVE LEGISLATION NEXT YEAR. IT MAY WELL BE THE MOST IMPORTANT FINANCIAL ISSUE THAT THE NEW PRESIDENT FACES IN 1989, ESPECIALLY IF A GLASS-STEAGALL BILL CAN BE PASSED BY CONGRESS THIS YEAR.

THE THRIFT INDUSTRY WAS INITIALLY CHARTERED TO OFFER A REPOSITORY FOR SAVINGS WHICH COULD BE FUNNELLED INTO RESIDENTIAL MORTGAGE LENDING. THIS APPROACH SERVES THE NATION WELL, WHEN THE GOAL OF EVERY FAMILY IS TO OWN ITS OWN HOME. BUT THRIFTS NOW DEVOTE A SUBSTANTIAL SHARE OF THEIR ASSETS TO NON-MORTGAGE ACTIVITIES, SO CERTAIN QUESTIONS MUST BE ADDRESSED.

FIRST, WHAT SHOULD A THRIFT BE ABLE TO DO? IN RETURN FOR MORTGAGE LENDING, THRIFTS NOW RECEIVE LONG-TERM, LOW-RATE ADVANCES FROM FEDERAL HOME LOAN BANKS FOR ANY USE, BROAD ACTIVITY CHOICE (SUCH AS INSURANCE AND REAL ESTATE), BENEFICIAL TAX TREATMENT, AND WIDE GEOGRAPHIC EXPANSION AUTHORITY. YET IT IS DIFFICULT TO TELL WHETHER THE BASIC THRUST OF THRIFTS IS TO REMAIN PRINCIPALLY

MORTGAGE LENDERS OR TO MOVE TOWARD FULL PURPOSE FINANCIAL SERVICES, OF WHICH MORTGAGE LENDING IS ONLY A PART.

THIS IS ESPECIALLY IMPORTANT WHEN WE CONSIDER WHICH ACTIVITIES THE FEDERAL GOVERNMENT SHOULD SANCTION THROUGH ITS DEPOSIT INSURANCE. SHOULD THEY MERELY BE THOSE ALLOWED BY CONGRESS? SHOULD STATES WHICH ALLOW FURTHER ACTIVITIES SHARE IN THE COST IF THE THRIFT GOES UNDER? SHOULD SUCH ADDITIONAL POWERS BE PART OF A THRIFT HOLDING COMPANY SO DEPOSIT INSURANCE DOES NOT SUPPORT THEM?

A SECOND CONCERN IS TO INCREASINGLY COORDINATE REGULATION IN THE FINANCIAL SERVICES INDUSTRY. JUST AS THE BRADY COMMISSION SPOKE OF A SINGLE MARKET FOR EQUITY AND EQUITY-DERIVATIVE PRODUCTS, SO THE DEPOSIT TAKING AND MORTGAGE LENDING MARKETS HAVE MULTIPLE PROVIDERS BUT A SINGLE GOAL.

THE THIRD QUESTION DEALS WITH THE MIXTURE OF COMMERCE AND THRIFT LENDING. IT DOES LITTLE GOOD TO KEEP THE STRUCTURE IN THE RECENTLY SENATE-PASSED PROXMIRE FINANCIAL MODERNIZATION ACT OF 1988 IF WE ALLOW THRIFTS TO EFFECTIVELY COME UNDER THE CONTROL OF COMMERCIAL PARTIES.

A FINAL CONCERN IS THE MAINTENANCE OF SAFETY AND SOUNDNESS. IN THE PROXMIRE BILL, WE RESPONDED TO THIS THROUGH THE CREATION OF A SEPARATE SECURITIES AFFILIATE, ADDITIONAL FIREWALL PROTECTION, AND GREATER REGULATORY SUPERVISION. PERHAPS THRIFT ACTIVITY SHOULD BE SO ARRANGED.

It is in the context of these concerns that we should review the future of the thrift industry.

I look forward to the testimony of the witnesses.

The CHAIRMAN. Senator Hecht.

OPENING REMARKS OF SENATOR HECHT

Senator HECHT. Thank you, Mr. Chairman.

So much has been said that I agree with, but if I can say it very simply, this has been caused by politics, mismanagement, and fraud. And how are we going to stop it in the future? We're going to have to have severe penalties for management, officers, and directors and let them know that the Government is not going to bail out everyone because of fraud and mismanagement.

The CHAIRMAN. Senator Bond.

OPENING REMARKS OF SENATOR BOND

Senator BOND. Thank you, Mr. Chairman.

What we've heard already suggests that the hearing today is going to be an interesting and exciting one. I believe there's been a slight divergence of views expressed in the testimony already submitted and in the statements of my good friend and colleague, the Senator from Utah. I, too, was one who supported the $15 billion bailout thinking that the lower sums requested and suggested in the other body were not adequate and I'm just interested to see the action begin.

The CHAIRMAN. Thank you, Senator Bond.

Secretary Gould, first, I want to join Senator Garn in his statement about your service. You've been a fine Under Secretary of the Treasury and the American people are in your debt. As you know, I also have disagreed with you from time to time on a number of issues, but you're the kind of person who doesn't look for disagreement but looks for ways in which we can work together to serve the American public and you've been a good man to work with in spite of the fact that we haven't always agreed.

We would be delighted to listen to your statements. I did want to pay tribute to you, Mr. Gould.

STATEMENT OF GEORGE D. GOULD, UNDER SECRETARY FOR FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. GOULD. I thank you, Mr. Chairman, and I thank you, Senator Garn. I sometimes find, Senator, not really here but in many places that my statements don't really change people's reactions or questions, so I'd be happy to have you go forward with your questions if you'd like.

The CHAIRMAN. We want to hear your words of wisdom. We really do.

Mr. GOULD. I will try to keep within your 10-minute rule.

Mr. Chairman, Senator Garn, and members of the committee, I appreciate this opportunity to return again today to testify on the condition of the Federal Savings and Loan Insurance Corporation [FSLIC]. Specifically, I will comment on why, from the administration's perspective, it is unnecessary to transfer resources from the American taxpayer to FSLIC so FSLIC in turn can close—or warehouse—insolvent savings institutions in this country.

BACKGROUND

First, a bit of history is in order.

When I first testified in front of this committee on March 4, 1986, I presented the administration's three-pronged strategy to revitalize the thrift industry and FSLIC. That strategy is as valid today as it was when we first proposed it. The challenge for Congress in the future will be to follow through and ensure that it is fully implemented.

To summarize briefly, our three-pronged strategy was—and still is—as follows:

First, the thrift industry as a whole had to be strengthened: Capital had to be increased and the growth of problem institutions had to be halted through improved supervision;

Second, FSLIC's resources had to be augmented to permit it to resolve a greater number of insolvent institutions; and

Third, the franchise value of ailing thrifts particularly had to be enhanced to lower FSLIC's resolution costs: New entrants into the industry can increase its overall capital base and long-term health.

We still believe that these three interrelated segments of our plan—if fully implemented and when finally in place—will strengthen the savings industry and allow it to continue to provide competitive housing finance into the next century.

The Treasury Department, working in conjunction with former Chairman Ed Gray and the Federal Home Loan Bank System, was directly involved with developing the financing prong of the strategy. In devising our plan to recapitalize FSLIC, two simple requirements were uppermost in our minds.

First, the time-tested notion of self-help was vital. The taxpayer was not to be called upon to bail out an industry that with some measure of sacrifice over time could substantially help itself. After all, many thrift owners and managers have profited greatly from their franchise and they presumptively were paying too small an insurance premium in the past. By structuring our recapitalization plan as a balance of the self-help between the Federal Home Loan Banks and the thrifts, a negative budgetary effect was avoided.

Second, the recapitalization plan needed to make substantial resources available up front to reduce the growth of insolvent institutions as quickly as possible.

You will recall that I testified in support of our FSLIC recapitalization plan on May 8, 1986. Based on our conversations at that time, Congress seemed to recognize the seriousness of the problems confronting both FSLIC and the thrift industry. I must confess that initially I had high hopes that Congress would act expeditiously. But 1986 wore on, and we were faced with numerous false starts in Congress and—to put it bluntly—industry-induced delays, which the General Accounting Office [GAO] testified cost FSLIC $6 million per day or over $2 billion per year. The situation was particularly disturbing since ours was the only plan on the table.

CHRONOLOGY OF EVENTS

Mr. Chairman, members of the committee, you know the history of the FSLIC recap effort and I won't repeat it here. I do have with me today a chronology of events for those who are interested.

Less than a year later and after waiting more than 15 months for Congress to act, we now hear cries from some quarters of the industry for a taxpayer bailout of massive, unprecedented proportions. These bleatings are predicated on the dubious assertion that the Government caused the thrifts' problems and, therefore, it is time for the Government to ante up to solve the problem. To my way of thinking, that is tantamount to a thrift executive saying that the Government made me take out my charter and then engage in housing finance for my livelihood—all under the protection of FSLIC's shield on my front door. Let me offer my observations on the two most frequently heard refrains in this regard.

First, it is argued by some in the thrift industry that the Government prematurely deregulated interest rates ceilings on time and savings accounts in depository institutions—regulation Q—and this in turn caused the industry's problems.

However, beginning in the late 1970's and extending into 1980, double digit inflation and high interest rates were making it next to impossible for thrifts to compete for deposits because of the unprecedented disintermediation occurring in the marketplace. Savers' funds were flowing into new products such as money market mutual funds. Simply put, had the Government not acted in a responsible manner to deregulate interest rates ceilings imposed by Congress, thrifts would have been disintermediated into the mist.

Second, others in the industry have said that either inadequate or too liberal investment opportunities caused the problems. I believe the limited asset powers authorized for thrifts by the Garn-St Germain Depository Institutions Act of 1982 were neither inadequate nor too liberal.

Was it the Garn-St Germain Act that caused Vernon Savings and Loan Association in Texas to fail—with 94 percent nonperforming loans?

It is true that a number of States have granted their State-chartered institutions broader asset powers than Federal thrifts enjoy and that this has contributed to pressure on FSLIC. As I testified more than 2 years ago, we need to reconcile States' authority to grant new thrift powers with FSLIC's financial responsibility to pick up the pieces when these State-chartered institutions fail. The administration has supported achieving a better balance by placing additional State-approved activities in separately capitalized holding company subsidiaries—if the Bank Board determines that this extra degree of protection for FSLIC is required.

The most forceful defense the Government has against these industry allegations of premature deregulation is that 85 percent of the FSLIC-insured institutions with 84 percent of the assets are solvent under GAAP accounting today. This great majority of the industry has been able to handle changes that the general economy and competition from other providers of financial services have been forcing on them over the past 10 years.

Now, in a surprising and abrupt change of view, a vocal part of the industry is saying that the problem is larger than the $5 billion in FSLIC assistance it advocated just last year, and that its problems have grown beyond its capacity to handle by itself.

The industry's spokesmen have not bothered, however, to tell the taxpayers of this country how much of their—our—money may be needed. A draft "Plan for Economic Revival," which was advanced, floated, and then withdrawn this past spring by one association gives an idea of the kind of assistance they feel is necessary—the establishment of four new Federal corporations and a massive amount of resources transferred from taxpayers to FSLIC. This is the same group that last year brought you a much heralded, but soon forgotten "Pay-As-You-Go Plan" that never quite managed to make it into legislative form. If we follow this course, we'll be headed for a "We-Pay-As-They-Go Plan."

PROPOSED RECAPITALIZATION FINANCE CORPORATION

One of these proposed corporations was a new Recapitalization Finance Corporation.

We believe that establishing such an entity would be an unnecessary and extremely expensive way to give assistance, especially if the only institutions that qualify for the assistance are the same ones already given capital forbearance under CEBA.

I also am struck by the number of academics and consultants who are quick to jump to a taxpayer remedy as the solution to FSLIC's problems. I am amazed at how quick some observers are to give up hope of resolving the problem by existing means and to rush to use someone else's money—yours and mine.

As I stated in my 1986 testimony to this committee:

> Anyone's estimate of the cost of resolving problem thrift cases entails considerable uncertainty. The hesitation is partially attributable to important variables—such as interest rates and regional real estate conditions—that may affect significantly the health of many institutions over time.

It is my understanding that Federal Reserve Board Chairman Alan Greenspan took a similar position during his recent appearance here. Rather than focus on numbers in the future that no one really knows, we should instead focus on numbers for which we can account. We know, for example, that over the next 3 years FSLIC will have about $19 billion to close insolvent institutions—as much as it says it can handle efficiently—and Chairman Wall has testified that $42 billion is available over 10 years for that same purpose.

Before we rush to a transfer of funds from taxpayers through FSLIC to insolvent institutions, we really ought to exhaust all other available resources. I should think that all committee members would be on their guard against a general taxpayer bailout for managers of failing and failed institutions, particularly since any such bailout would be charged to the committee's annual budget allocation and force harder choices among other programs under the committee's jurisdiction that already compete for limited resources from the Federal Government.

As I indicated at the beginning of my statement, the challenge for Congress in the future will be to fully implement the three-pronged strategy we proposed 2½ years ago. Given FSLIC's considerable resources over the next several years, it is unnecessary to act hastily or to release the industry from obligations established fairly less than a year ago.

If Congress wants to take further steps to put the administration's strategy in place, I can suggest the following steps to help both FSLIC and the thrift industry before you call on the American taxpayer. Let me just list these for you briefly; and we can discuss them in the Q and A: More recapitalization financing; thrift charter enhancement; facilitate acquisitions; use private capital to back additional State-chartered authorities instead of FSLIC-insured funds; strengthened enforcement authority; and extend expiring tax provisions.

In closing, I urge this committee in the strongest possible terms to resist mounting pleas for an unnecessary, budget busting bailout of FSLIC. The precious resources of our taxpayers should not be tapped until the existing plan has had a chance to work and all other reasonably available resources have been used. In any case, no single change in existing mechanisms should be made without reevaluating the full array of institutional arrangements.

Important strides have been made in all three areas of the administration's 1986 plan, although there is still more to do. Programs now in place should be given time to work—and a better data base assembled—before taxpayer money is thrown at the problem. All existing resources should be utilized first and all nonexpenditure solutions should be implemented. Obviously, more steps along the line I have suggested can and should be taken.

If additional resources become necessary at a later date, then the Bank Board, the administration and the Congress will have time—and the obligation—to carefully reconsider the full range of interrelated policy issues with respect to our regulatory and deposit insurance structure.

[The complete prepared statement of Mr. Gould follows:]

TESTIMONY OF THE HONORABLE
GEORGE D. GOULD
UNDER SECRETARY FOR FINANCE
U.S. DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
TUESDAY, AUGUST 2, 1988

Mr. Chairman, Senator Garn, and Members of the Committee, I appreciate this opportunity to return again today to testify on the condition of the Federal Savings and Loan Insurance Corporation (FSLIC). Specifically, I will comment on why, from the Administration's perspective, it is unnecessary to transfer resources from the American taxpayer to FSLIC so FSLIC in turn can close -- or warehouse -- insolvent savings institutions in this country.

I. The Administration's Three-Prong Strategy

First, a bit of history is in order.

When I first testified in front of this Committee on March 4, 1986, I presented the Administration's three-pronged strategy to revitalize the thrift industry and FSLIC. That strategy is as valid today as it was when we first proposed it. The challenge for Congress in the future will be to follow through and ensure that it is fully implemented.

To summarize briefly, our three-pronged strategy was -- and still is -- as follows:

- First, the thrift industry as a whole had to be strengthened: capital had to be increased and the growth of problem institutions had to be halted through improved supervision;
- Second, FSLIC's resources had to be augmented to permit it to resolve a greater number of insolvent institutions; and
- Third, the franchise value of ailing thrifts particularly had to be enhanced to lower FSLIC's resolution costs: new entrants into the industry can increase its overall capital base and long-term health.

For a more complete description of our triad approach, I refer you to my March 4, 1986, testimony. It was our opinion, however, that without the additional capital, the FSLIC would be forced to continue deferring the resolutions of many insolvent thrifts. With the appropriate financial and organizational resources, the Federal Home Loan Bank Board (FHLBB) and the FSLIC could set more ambitious targets and resolve more cases, more quickly -- and in a more cost effective manner. The attractive interest rate environment then prevailing provided the ideal window of opportunity to move ahead to resolve ailing thrift institutions.

At that time, the Administration believed an immediate recapitalization of the fund would reaffirm depositor confidence in the health and stability of the thrift industry and the viability of the deposit insurance funds. Furthermore, prompt handling of the most debilitated thrifts would help healthy thrifts by lowering their cost of deposits, which had been bid up by feeble institutions calling for funds virtually at any price.

We still believe that these three inter-related segments of our plan -- if fully implemented and when finally in place -- will strengthen the savings industry and allow it to continue to provide competitive housing finance into the next century. Federal Home Loan Bank Board Chairman Dan Wall recently testified before the Committee on the steps the Board is taking to aggressively implement this strategy, and in the interest of time, I will not repeat that description. New capital regulations are in place, institutions without adequate capital are supervised and regulated more closely, examination forces are being upgraded, new entrants and acquirors are more actively pursued, and problem cases are being resolved within the limits of existing resources and market capacities -- both financial and, as importantly, managerial.

II. The Treasury/FHLBB FSLIC Recapitalization Plan

The Treasury Department, working in conjunction with former Chairman Ed Gray and the Federal Home Loan Bank System, was directly involved with developing the financing prong of the strategy. In devising our plan to recapitalize FSLIC, two simple requirements were upper-most in our minds.

First, the time-tested notion of self-help was vital. The taxpayer was not to be called upon to bail-out an industry that with some measure of sacrifice over time could substantially help itself. After all, many thrift owners and managers have profited greatly from their franchise and they presumptively were paying too small an insurance premium in the past. In addition, by structuring our recapitalization plan as a balance of the financing burden of the recapitalization of the fund between the Federal Home Loan Banks and the thrifts, a negative budgetary effect was avoided.

Second, the recapitalization plan needed to make substantial resources available up front to reduce the growth of insolvent institutions as quickly as possible. To this end, we devised a unique industry-based plan that would enable the FSLIC to devote about $25 to $30 billion over 5 years to handling its sizeable load of problem cases, while in all likelihood being able to phase-out the special premium assessment over the same period.

Let me stress that our proposal, by providing a $15 billion recapitalization which would have supplied up to $25 to $30 billion to FSLIC over 5 to 6 years, was adequate to cover even the then most pessimistic estimates of the costs involved.

You will recall that I testified in support of our FSLIC recapitalization plan on May 8, 1986. Based on our conversations at that time, Congress seemed to recognize the seriousness of the problems confronting both FSLIC and the thrift industry. I must confess that initially I had high hopes that Congress would act expeditiously to approve an industry self-help plan -- that involved no appropriation from the U.S. taxpayer -- so that FSLIC could go about its business of closing down hopelessly insolvent thrifts. But 1986 wore on, and we were faced with numerous false starts in Congress and -- to put it bluntly -- industry-induced delays, which the General Accounting Office (GAO) testified cost FSLIC $6 million per day or over $2 billion per year. We obviously were distressed by these delays since the resolution costs for FSLIC were accumulating at a time when FSLIC (assuming the proper resources) should have been aggressively acting to resolve its caseload of problem institutions. The situation was particularly disturbing since ours was the only plan on the table.

Not only did active industry opposition slow the legislative pace, but in the final days of the 99th Congress, controversial and extraneous amendments began to materialize in both the House and Senate -- amendments which had absolutely nothing to do with enhancing FSLIC's resources or protecting depositors. Only in the final days of the session were attempts made to bounce a loaded-down FSLIC recapitalization plan back and forth between the two houses of Congress. Meanwhile, sick, insolvent thrifts grew sicker.

In 1987, we were faced with three general problems left over from the previous year:

- o industry attempts to reduce the amount of their contribution to revitalizing their insurance fund;
- o the addition of more controversial, and extraneous amendments that had nothing to do with helping FSLIC or protecting depositors; and
- o new, significant obstacles to FSLIC's operation, both in terms of its ability to properly supervise and, when necessary, close problem institutions, and to attract outside capital and potential acquirors for troubled thrifts.

Throughout this period, Treasury Secretary Baker, others in the Administration, and I repeatedly urged Congress to act to bolster FSLIC's resources. In the end, only after the threat of a Presidential veto did we get two-thirds of the financing we originally proposed -- and this only after the House of Representatives voted overwhelmingly for only one-third, with the Senate going as far as one-half the financing. Even then we ended up with new restrictions on the Board's ability to supervise and resolve problem institutions (the so-called "forbearance" provisions) and numerous disincentives to enhance the acquisition of troubled thrifts.

III. Current Cries for a Taxpayer Bail Out

Less than a year later and after waiting more than fifteen months for Congress to act, we now hear cries from some quarters of the industry for a taxpayer bailout of massive, unprecedented proportions. These bleatings are predicated on the dubious assertion that the Government caused the thrifts' problems and, therefore, it is time for the Government to ante up to solve the problem. To my way of thinking, that is tantamount to a thrift executive saying that the Government made me take out my charter and then engage in housing finance for my livelihood -- all under the protection of FSLIC's shield on my front door. Let me offer my observations on the two most frequently heard refrains in this regard.

First, it is argued by some in the thrift industry that the Government prematurely deregulated interest rates ceilings on time and savings accounts in depository institutions (Regulation Q) and this in turn caused the industry's problems. It is true that after years of simply extending Regulation Q, Congress finally created the Depository Institutions Deregulation Committee in 1980 to remove ceilings on savings accounts and phase-out the differential that existed between commercial banks and savings institutions. Obviously, there were those in the industry who didn't like the move to market-determined rates -- and who would after years of protection by the Federal Government.

However, beginning in the late 1970s and extending into 1980, double digit inflation and high interest rates were making it next to impossible for thrifts to compete for deposits because of the unprecedented disintermediation occurring in the marketplace. Savers' funds were flowing into new products such as money market mutual funds. Simply put, had the Government not acted in a responsible manner to deregulate interest rates ceilings imposed by Congress. thrifts would have been disintermediated into the mist.

Second, others in the industry have said that either inadequate or too liberal investment opportunities caused the problems. I believe the increased asset powers authorized for thrifts by the Garn-St Germain Depository Institutions Act of 1982 were neither inadequate nor too liberal. Among other powers, the Act authorized thrifts to offer checking accounts to their commercial customers, permitted commercial loans in an amount equal to up to 10 percent of assets, and expanded consumer lending authority from 20 percent of assets to 30 percent of assets.

Was it the Garn-St Germain Act that caused Vernon Savings and Loan Association in Texas to fail -- with 94% nonperforming loans? Did that Act cause the problems of the American Savings and Loan Association in California? Did this limited deregulation at the federal level cause the failure of numerous state-chartered institutions? A review of the facts will show that the answer to these questions is: no.

It is true that a number of states have granted their state-chartered institutions broader asset powers than federal thrifts enjoy and that this has contributed to pressure on FSLIC. As I testified more than two years ago, we need to reconcile States' authority to grant new thrift powers with FSLIC's financial responsibility to pick up the pieces when these state-chartered institutions fail. The Administration has supported achieving a better balance by placing additional state-approved activities in holding company subsidiaries -- if the Bank Board determines that this extra degree of protection for FSLIC is required. State-chartered thrift institutions could still engage in new business opportunities -- properly supervised

-- but with an important new distinction. Instead of operating with the backing of a federal deposit insurance fund, those managers who wanted to engage in new activities would have to do so with their own capital at risk -- up front in a separately capitalized subsidiary -- instead of with FSLIC-insured funds.

The most forceful defense the government has against these industry allegations of premature deregulation is that 85 percent of the FSLIC-insured institutions with 84 percent of the assets are solvent under GAAP accounting today. This great majority of the industry has been able to handle changes that the general economy and competition from other providers of financial services have been forcing on them over the past 10 years.

Now, in a surprising and abrupt change of view, a vocal part of the industry is now saying that the problem is larger than the $5 billion in FSLIC assistance it advocated just last year, and that its problems have grown beyond its capacity to handle by itself. Therefore, you undoubtedly can expect this portion of the industry to continue to step up its calls for general assistance from taxpayers.

The industry's spokesmen have not bothered, however, to tell the taxpayers of this country how much of their -- our -- money may be needed. A draft "Plan for Economic Revival," which was advanced, floated, and then withdrawn this past spring by one association gives an idea of the kind of assistance they feel is necessary -- the establishment of four new federal corporations and a massive amount of resources transferred from taxpayers to FSLIC. This is the same group that last year brought you a much heralded, but soon forgotten "Pay-As-You-Go Plan" that never quite managed to make it into legislative form. If we follow this course, we'll be headed for a "We-Pay-As-They-Go Plan."

One of these proposed corporations was a new Recapitalization Finance Corporation (RFC) based on the concept of the RFC established in the 1930s. The new RFC would purchase preferred stock and or subordinated debt, thus increasing the capital of well managed but poorly capitalized institutions; e.g., those that qualify for capital forbearance under the Competitive Equality Banking Act (CEBA). Interest-bearing RFC notes would be used to purchase the preferred stock which then would be paid off by receiving institutions as they recovered. The plan would have the RFC capitalized by periodic infusions of capital from both the Federal Deposit Insurance Corporation (FDIC) and FSLIC sufficient to buy zero-coupon Treasury securities in an amount that would guarantee and eventually pay off the principal of the notes. The Treasury would pay the interest on the notes and the Federal Reserve would be expected to accept the notes as collateral for borrowing.

We believe that establishing such an RFC would be an unnecessary and extremely expensive way to give assistance, especially if the only institutions that qualify for the assistance are the same ones already given capital forbearance under CEBA. Also, it seems unlikely that the FSLIC and the FDIC could provide the necessary periodic capital infusions. Furthermore, the FSLIC already has the authority to issue income capital certificates, which serve the same purpose that the proposed preferred stock and/or subordinated debt would serve: that is, increasing capital in troubled institutions.

The Plan for Economic Revival also would have established asset holding corporations (AHCs) -- one for delinquent home mortgage loans and one for non-mortgage loans. These AHCs would purchase troubled assets from institutions and then hold them -- and the underlying properties -- off the market.

At the request of Congress, the FHLBB published a study last February attempting to determine the feasibility of establishing an AHC. The report concluded that in light of the estimated organizational problems and huge costs of such an organization, it would be preferable -- and more cost effective -- to assist private institutions holding these troubled assets. The private sector is usually able to manage such assets at a considerably lower cost than a bureaucracy engaged in central planning. Before anyone contemplates starting down the road of creating new federal agencies, stop and ask yourself: does Washington do a better job of managing properties and assessing local economic conditions and markets?

I also am struck by the number of academics and consultants who are quick to jump to a taxpayer remedy as the solution to FSLIC's problems. I have seen figures that range from $64 billion upwards to $100 billion -- two and three times what the GAO estimates, for example. I'm not sure what their assumptions are -- or who their clients are for that matter -- but I am amazed at how quick some observers are to give up hope of resolving the problem by existing means and to rush to use someone else's money -- yours and mine.

As I stated in my 1986 testimony to this Committee:

> "Anyone's estimate of the cost of resolving problem thrift cases entails considerable uncertainty. The hesitation is partially attributable to important variables -- such as interest rates and regional real estate conditions -- that may affect significantly the health of many institutions over time."

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It is my understanding that Federal Reserve Board Chairman Alan Greenspan took a similar position during his recent appearance here. Rather than focus on numbers in the future that no one really knows, we should instead focus on numbers for which we can account. We know, for example, that over the next three years FSLIC will have about $19 billion to close insolvent institutions -- as much as it says it can handle efficiently -- and Chairman Wall has testified that $42 billion is available over ten years for that same purpose.

Before we rush to a transfer of funds from taxpayers through FSLIC to insolvent institutions, we really ought to exhaust all other available resources. I should think that all Committee Members would be on their guard against a general taxpayer bailout for managers of failing and failed institutions, particularly since any such bailout would be charged to the Committee's annual budget allocation and force harder choices among other programs under the Committee's jurisdiction that already compete for limited resources from the Federal Government.

IV. Actions Congress Can Take to Avoid Tapping Taxpayers Resources

As I indicated at the beginning of my statement, the challenge for Congress in the future will be to fully implement the three-pronged strategy we proposed two and one half years ago. Given FSLIC's considerable resources over the next several years (together with those of the Federal Home Loan Bank System), it is unnecessary to act hastily or to release the industry from obligations established fairly less than a year ago.

If Congress wants to take further steps to put the Administration's inter-related triad in place, I can suggest the following steps to help both FSLIC and the thrift industry before you call on the American taxpayer. Let me list these for you briefly:

- More Recapitalization Financing

The structure of the Administration's recapitalization plan is now in place, it works as we indicated, and it is flexible in the event that additional funds are needed. This structure could be expanded, if necessary, using various sources (the industry or the Federal Home Loan Banks, for example) both for the capital to buy zero coupon Treasuries to guarantee the defeasance of the principal and for the money to cover interest payments on the bonds issued.

- Thrift Charter Enhancement

Thrift charter enhancement provides a vital means of expanding the capital base of the industry. In general, we favor efforts that will attract outside capital while maintaining the safety and soundness of the industry.

On April 27 of this year, Assistant Secretary for Domestic Finance Charles Sethness testified before this Committee on "The Thrift Charter Enhancement Act of 1988" (S. 2073), introduced by Senator Karnes. We are pleased that the Committee recently reported a revised bill to meet a number of our concerns. We still would urge you to take an extra step and repeal the counter productive cross-marketing restrictions contained in the Competitive Equality Banking Act.

- Facilitate Acquisitions

The resolution costs for FSLIC can be reduced, not only by enhancing the franchise value, but also by facilitating acquisitions. As I have testified previously, inter-industry acquisitions are a touchy subject, but the acquisition logic is straightforward and undeniable.

Insolvent institutions have imposed real costs on healthy thrifts as well as FSLIC. Since the Administration -- and hopefully Congress -- is not in the mood for a budget busting bailout, all non-expenditure solutions should be explored. This includes removal of the cumbersome bidding priorities for emergency acquisitions of failing thrifts under Sec. 408(m)(3)(B) of the National Housing Act.

- Use Private Capital to Back Additional State-Chartered Authorities Instead of FSLIC-Insured Funds.

As I indicated in 1986 and again this morning, Congress should reconcile states' authority to structure new thrift products and services with FSLIC's responsibilities, especially now given its limited resources. Use of a separately capitalized subsidiary of a holding company -- with private capital as the line of defense, rather than FSLIC -- is our preferred approach.

- Strengthened Enforcement Authority

The Administration generally supports the strengthened enforcement provisions in the Proxmire Financial Modernization Act (S. 1886) that is now pending before the House Banking Committee. Many of these authorities were requested by former Chairman Ed Gray four years ago and have been endorsed by Chairman Wall. For example, the regulators would be empowered to issue temporary cease and desist orders where an institution's records were in disarray or not available. For whatever reasons, Congress has delayed in giving the federal regulators the tools they have long requested to carry out their supervisory responsibilities.

o Extend Expiring Tax Provisions

Extension of the tax provisions that affect the FSLIC's ability to arrange for assisted acquisitions of troubled thrift institutions also should be considered by the Congress. These provisions, which under current law will expire at the end of 1988, maximize the value of FSLIC assistance. One such provision provides that assistance paid by the FSLIC in connection with an assisted acquisition will not be considered taxable income. The other provisions clarify that a FSLIC-supervised merger or acquisition can quality as a tax-free reorganization, such that the net operating and built-in tax losses of troubled institutions can be utilized fully by a subsequent acquiring institution. The extension of these provisions would allow FSLIC to resolve a greater number of cases and to resolve them more quickly than it could if the provisions were allowed to expire.

VI. Conclusion

In closing, I urge this Committee in the strongest possible terms to resist mounting pleas for an unnecessary, budget busting bailout of FSLIC. The precious resources of our taxpayers should not be tapped until the existing plan has had a chance to work and all other reasonably available resources have been used. In any case, no single change in existing mechanisms should be made without re-evaluating the full array of institutional arrangements.

Congress passed the recapitalization legislation less than 12 months ago. The FHLBB has a plan in place to close approximately 100 institutions in Texas and 100 additional institution in FSLIC's current caseload by the end of 1988. In addition, they expect by the end of 1989 to have resolved all 259 institutions in FSLIC's caseload as of December 1987. The Bank Board believes that the financial resources available to them will cover the costs of this ambitious plan.

In other words, important strides have been made in all three areas of the Administration's 1986 plan, although there is still more to do. Programs now in place should be given time to work (and a better data base assembled) before taxpayer money is thrown at the problem. All existing resources, including those of the Federal Home Loan Bank System, should be utilized first

and all non-expenditure solutions should be implemente
Obviously, more steps along the line I have suggested
should be taken.

If additional resources become necessary at a late
then the Bank Board, the Administration and the Congres
have time -- and the obligation -- to carefully recons
full range of inter-related policy issues with respect
regulatory and deposit insurance structure.

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The **Chairman**. Thank you, Secretary Gould.

Mr. Levy, this may be the last time that you appear before a committee that I chair, so I want to express my gratitude to you. I'm very proud of the fact that one of the real leading lights in this industry is from Wisconsin. You've been a very, very distinguished financial executive and you've done a superb job in our State and in the industry and we are very proud of you. Go ahead, sir.

Mr. **Levy**. Mr. Chairman, could I defer to Mr. Sandler and we go in the sequence of Mr. Sandler, Mr. Shackelford and then back to me?

The **Chairman**. Fine. Any sequence you gentlemen prefer is fine with me. Mr. Sandler, go right ahead.

STATEMENT OF HERBERT M. SANDLER, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, WORLD SAVINGS & LOAN ASSOCIATION, OAKLAND, CA

Mr. **Sandler**. Mr. Chairman, Senators, members of the committee, first of all, I have two preliminary comments. One, what I shall discuss today is not a partisan issue since the mistakes which we shall describe span both Democratic and Republican administrations.

Two, what I say today will probably hurt my company since we are regulated and I am likely to offend powerful people, but someone has to speak up publicly and say it like it is.

How does one in 10 minutes communicate the pent-up accumulated anger and frustration of 10 years, 10 years of observing flawed public policy initiatives, followed by bungled, unplanned, and uncoordinated implementation of these policies? Ten years of listening to economists and public officials and others testify before this and other committees and issue press releases by the truckful, and what they are spouting and have been spouting is pure unadulterated nonsense right out of Alice in Wonderland.

We are in a big, big black bottomless pit, which is literally getting bigger every day, but you and we are told, don't worry, it's under control. Well, it's not under control and everyone who's conversant with the facts without a hidden agenda knows it.

Gentlemen, on the most conservative basis, the losses are at least $50 billion. That is if you're a hopeless optimist. I used to be one, but the last 10 years have made me cynical and my personal realistic estimate of the loss is at least $60 to $80 billion and I would not be surprised if it were $100 billion. Probably the greatest financial scandal in U.S. history, a ticking time bomb, and it's ready to blow.

And these losses, gentlemen, are as of today. It will be more tomorrow and much, much more if the new administration and Congress do not act pretty damn fast.

NEXT ADMINISTRATION MUST ACT QUICKLY

And for two reasons. One, there are institutions operating out there with little or no capital, distorting both the deposit gathering and lending markets and taking on additional significant interest rate and credit risks; and two, the annual operating losses, assuming no additional writedowns, no additional losses, and no new problems, range from $6 billion on the low side—annual operating losses—and up to $12 billion on the high side. And, gentlemen, these operating losses compound.

Let me take 1 minute more to tell you who I am. I am chairman of World Savings, a $14 billion company with almost 200 offices in the States of California, Colorado, Kansas, Texas, and Washington and we lend in 15 States. We have been one of the most profitable thrifts in the country with high net worth and low nonperforming assets, one of only two publicly held S&L's with an A rating, and incidentally, with all this talk of deregulation, we make only residential loans and we keep them in the portfolio.

We are also incidentally, one of the largest taxpayers in the financial services business, having paid over $100 million in Federal and State taxes in each of the last 2 years.

I believe today that I'm speaking on behalf of some 2,000 healthy savings and loans whose focus continues to be on residential lending and who believe that they can continue to be the key players in housing Americans, the key player in a system which has done the best job—not perfect, but the best job of housing its citizens of any country in history. Savings and loans which make loans for housing and which are viable savings and loans, despite some God awful public policy initiatives which were incompetently implemented and despite efforts by some to eliminate us as an industry for their private reasons.

My assignment as leadoff witness is to briefly summarize how we got there and I'd like to turn your attention to the exhibit which is called "Genesis, The Creation of Astronomical Losses."

The first item, deregulation, bungled and unplanned. We're not talking so much about the fact that you deregulated the liabilities, but why didn't you let the regulators deregulate assets first? Why didn't you let them make ARM's? Our problem you all know and as Senator Proxmire pointed out on July 14, is we were forced to borrow short and lend long. We begged for the right to make adjustable rate mortgages since 1973 and we were refused continuously and then you go through the process of deregulating liabilities and we're caught in a vise in which we're forced to lose money.

You want to talk about being bungled? You removed broker limitations which caused directly substantial billions of dollars of losses and then, having done all this, you put no guidelines in place for how people operate, regulators or managers, in a new deregulated world.

Senator Garn is right. The State legislatures are very much at fault. They created the free-for-all, in which wide open authorities were granted. California, Florida and other States, anything goes. Invest in restaurants, windmill farms, stud farms, all this with insured deposits. That's insane.

STATE REGULATORS

Let's look at the State regulators—totally irresponsible. In California, a total abdication of supervisory and regulatory responsibility, uncontrolled chartering of new institutions with new types of ownerships. Can you imagine giving developers the right to use insured deposits for development activities? That's what the deregulatory process did.

OMB—head in the sand—that's the nicest way I could put it. Their refusal to permit an increase in supervisory staff which the industry is asking for and which the industry is paying for and OMB says no, no additional staff. Insanity.

The Federal Home Loan Bank Board—system—and I'll put this as nicely as I can—the system at best was ill prepared. We were warning them what was going on. We were telling the regulators what would happen and they didn't know what to do. They had lack of management competence. To put it as nicely again as I can, they were well intentioned but they had inadequate management experience and talent and they were not able, unfortunately, to rise to the occasion.

Supervisors and examiners were totally out of their depth. They were not competent by training, attitude, psychology, disposition, and ability to supervise in a deregulated world and they were overwhelmed. And, gentlemen, that's really the sore spot because the industry was active. We did call the regulators. We called the Chairman of the Federal Home Loan Bank Board. We called the supervisory agencies. We said "*x* is doing this" and we were ignored—ignored—and I can show you a list of institutions probably with losses of $20 to $25 billion, most of whom I called regulators about and supervisors about and told what they were doing in detail and I was ignored.

And, yes, the trade associations, they made their contribution. And I say the trade associations. It wasn't me and it wasn't Levy and it wasn't Shackelford, and neither was it many others of us. They were myopic. They were caught up in the deregulatory fad and then they had the old trade association problem—you have to save everybody, no matter how incompetent, no matter how weak. And clearly they contributed to the problem. We paid $3.5 billion for the trade association's incompetence. How much more do you want us to pay, those of us who were innocent and warned of the problems?

And all this then was exacerbated by the depression in the Southwest and Colorado. I would like to direct your attention now to the second board, one of several stories I'd like to tell you about.

FCA LOSS

The FCA loss. That's undoubtedly going to be $2 billion on the low side and no matter what will be said in the papers, I suspect as high as $3 or $4 billion—certainly $2 billion. All, 100 percent, due to regulatory mismanagement. First of all, an individual by the name of Charlie Knapp controlled this institution. They grew from 1980 to 1983 from $500 million to $10 billion through using the bucket shop—the telephone banks calling for money. The broker money I might point out—that nice deregulation that we had—and utilized that to go to $10 billion. He had phony accounting. He had terrible loans. The whole operation smelled.

And essentially we called them—we called the supervisory agent and said, "Stop these guys." Two percent net worth. Mistake No. 1, they let them alone. Mistake No. 2, when they ran out of steam they made a deal with American Savings, a very well run, $10 billion shop also, which had very high capital. It was obvious that what Knapp wanted was to get hold of this capital so he could continue to play his high risk, highroll operation and double his bets. I must have called Chairman Gray 50 times warning him of what was going on. I spoke to the supervisory agent 50 times. I visited staff of the Federal Home Loan Bank Board. I described the bad lending. I described the phony accounting. I described the way this gentleman operated. And do you know they were approved and Knapp did exactly what I projected. He started to highroll again and now they were $20 billion and within a year they got to $31 billion—high risk. What they did was that they bought mortgage-backed securities and made fixed rate loans supported by short-term deposits or reverses in the capital markets. My God, it was run amock, as a result of that situation.

That was bad enough. The SEC closes them down because of accounting practices, big losses written off, and now we have the opportunity for the third macro error. What happens? The Federal Home Loan Bank in San Francisco now is in charge of this thing. They say, "Shrink this institution" and in fact for the next few months they went under new management. Knapp was thrown out. They went from $31 billion to $24 billion.

Is my time up or do I have another minute?

The CHAIRMAN. Your time is up. Can you wind up in a minute or so?

Mr. SHACKELFORD. Mr. Chairman, can I give him two of my minutes?

The CHAIRMAN. All right. That will be 8 minutes for Mr. Shackelford.

Mr. SANDLER. Thank you. What happens is they shrunk from $31 billion to $24 billion. The new general manager, a gentleman by the name of Popejoy and Chairman Gray concocted a scheme—gee, we're not going to be able to get out of this thing if we shrink; what we've got to do is grow out of the problem; we've got to grow out of the problem. And what does Chairman Gray do? He authorizes this institution to grow from $24 billion back up to $35 and $36 billion by doing the same thing—long-term mortgage-backed securities, reverses in the capital market with short-term borrowings—the largest interest rate bet in history and it's being micromanaged by the Chairman of the Federal Home Loan Bank Board. As a matter of fact, they took jurisdiction over American Savings away from the Federal Home Loan Bank of San Francisco, unfortunately, not the last time that the Federal Home Loan Bank Board has taken away a problem case from its rightful and proper supervisor.

What did this result in? This has resulted in $2 to $5 billion in losses. What do any of our innocent S&L's who are well run have to do with this magnificent piece of regulatory incompetence? And the problem is, this isn't an isolated case. I can show you $20 to $30 billion of similar losses caused by similar kinds of ineptitude.

Thank you, Don. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Sandler.

Mr. Levy or Mr. Shackelford, who prefers to go next?

Mr. LEVY. I'll go next.

STATEMENT OF GERALD J. LEVY, PRESIDENT, GUARANTY SAVINGS & LOAN ASSOCIATION, MILWAUKEE, WI

Mr. LEVY. Mr. Chairman, Senator Garn, members of the committee, first, let me thank you, Senator, for the kind remarks and I would extend them back and we're going to miss you. You've been a great representative from the State of Wisconsin and I don't know if I can speak on behalf of the people of Wisconsin, but we will definitely miss you.

QUESTION OF GROWTH

I'd like to address this question of growth. Under Secretary Gould talked about one of the three parts of the plan was to limit growth. One should understand that while we all agree that that seems to make eminent sense, that has not been the course of action; that in fact we have continually watched the Bank Board implement a program that believes that growth is one of the solutions to the problem.

Now this has been a terribly disturbing thing to us for a long period of time. I chaired a committee several years ago—I emphasize the things I'm going to say today I'm not saying on behalf of the League—industry trade groups are difficult things to work in. Senator Garn talked about being in a conference committee where he took positions against forbearance. Trust that in the inner councils of industry groups, many of us speak out but you get shouted down as well.

But the fact is that growth has been one of the keys in all of this. Let me start and just touch on something that was said here on the FCA. The first or second day of March 1987 raised some issues about FCA and the kind of interesting bets that were being placed. At that time they had increased the purchase of mortgage-backed securities by $10 billion with the consent of the Bank Board. Those $10 billion were pledged at Wall Street firms, borrowed against short-term funds, short-term rates, with presumably some hedging of the interest rate risk.

I was appalled by it and asked and arranged a meeting with—first, we complained to the Bank Board, to no avail. I then, the first week in March had a meeting with Chairman Volcker and pointed out the deep concern we had about this kind of hedging strategy. It seemed apparent to us, based on the experience that the mortgage-backed securities markets were showing that hedging strategies were certainly fallible and there was substantial risk involved. We were concerned about the size of the positions. We were concerned about the risks to the institution, the risks to the street firms, and most importantly, the fallout and potential loss that would be paid by the savings and loan industry.

I asked for two things. I asked, one, unwind the position while it still was not underwater at the time; or second, the theory around at the time was that a check was being written that would be paid by the savings and loan industry, that we would pay for all the embedded losses that were incurred. And I asked at the time, why don't we set up a separate tab. If the Government in its wisdom wants to take an interest rate gamble, then let them take it on their tab, not on ours, because I certainly didn't believe in the kind of hedging protections that were available and I thought the risks were extraordinary.

I wasn't alone in these positions. Unfortunately, nothing happened. The position stayed in place. In early April 1987, we had a massive reversal in the mortgage-backed securities markets that as government bond prices plunged rates soared and within a very short period of time we had a $1.6 or $1.8 billion loss in that portfolio. That portfolio total cost us $17 billion.

Now I share Mr. Sandler's concern. It appalls me to have to pay up and pony up for a bill that we not only didn't encourage but tried to discourage and tried to prevent.

Let me go further on this question of limiting growth because let's take it into 1988 and I think the statement by you, Mr. Chairman, in the Congressional Record on July 14 hits on the current policy of the Board and it gets into this whole question of forbearance.

FORBEARANCE

Senator Garn, I shared your concern from the beginning on forbearance. In inner councils I was outvoted. I didn't believe in it then. I don't believe in it now because as I've seen forbearance move forward, what I've seen are business plans being approved by institutions that have little or no capital that are allowed to file business plans that are based on massive growth, doubling in size of institutions, and the two most current situations referred to in the Congressional Record were the cases of Columbia Savings in Colorado and Ben Franklin in Houston, both institutions with little or no capital. In fact, Columbia had sharply negative capital, close to $62 million—and allowed to get into massive positions doubling the size of the institution.

The fact is that there is an embedded belief within the regulatory system that we can grow out of this problem. A major problem that we faced from 1983 and 1984 on was the sense that institutions caught in this interest rate mismatch could grow out of it by doubling or tripling in size and acquiring new assets that would offset the losses that were embedded in their original portfolio. In virtually every case, this has proved to be a flawed philosophy.

So I'm addressing the concern about what should be done. My God, what should be done is that institutions that have little or no capital should not be allowed to grow. I'll go one step further. It's something I've been saying for the past 3 or 4 years. Not only shouldn't they be allowed to grow, forget about the powers that are granted them by State regulators or by Federal regulators, institutions without capital should be required to go back to the basics in this business—basic residential lending. If you don't have capital on the table, you ought to be operating in the most basic mode.

So I, for one, would argue strongly that as forbearance is reviewed it be most carefully reviewed, that in any situation where a forbearance petition is filed unless new capital in the form of cash is coming into the table those institutions if they're kept around they should be severely limited in terms of exercising powers and authority and, second, they certainly should not be allowed to grow.

I'm just going to take another minute or two just to comment on two other points. One, the Southwest plan which seems to me to be an extension of the whole concept of growth without capital.

The first two instances did not follow what I thought was a very good initial proposal. The idea of a Southwest plan was one, to attract fresh capital into the business and, two, to close redundant facilities and achieve cost savings. It seems to me that the first two brought in almost no capital. We had 1.1 percent capital in the first case, a $60 million savings and loan which had I believe something like $12 or $14 million in mortgages, was turned into a $600 million association. It put up $6 million in capital. In the second case, it didn't put up any cash. They had no capital. They put up $25 million in subordinated debt that represented six-tenths of 1 percent of the assets. To me, that's perpetuating the problem. Those institutions without capital, I underscore, shouldn't be growing.

Mirror Bank came on with cash and that one at least there was outside cash brought in, but it is a continuation of allowing institutions to remain on the street that are operating without capital, putting the entire system at risk. We've looked at the losses, the losses that were referred to, these billion dollar a month losses, are losses in the insolvent institutions. I tell you that by maintaining the operation of these institutions, the pricing techniques and the risks that they take force solvent institutions to be recognizing and taking daily losses that override the $1 billion a month that we've talked about at this point.

My last point is relative to the use of notes by the Bank Board in resolving cases. Yes, CEBA provided for a bonding procedure through FICO. It called for $10.8 billion in bonding over 3 years. In point of fact, it had an annual cap which is being adhered to, but the Board is moving sharply ahead through the use of notes.

The concern with the notes is are they debt? Yes, the accounts of individual depositors—I was very pleased to hear you restate the fact that Congress stands behind the customer deposits. Will it stand or does it stand behind the notes that are being monetized at the Federal Home Loan Banks? If not, in effect, we're going to tap out $12 billion of capital in the Federal Home Loan Banks which represents about 35 to 40 percent of the GAAP capital of this business and it represents probably 100 percent of the tangible GAAP capital of the business. So if the capital of the bank system is lost, we just exacerbate the problem. We just increase and heighten the entire problem.

In closing, let me just say two things because I was there, two things that I keep hearing coming to the fore and I must disclaim. One, I was involved in the recap discussions. I never in any discussion said we had a $5 billion problem or a $10 billion problem. I talked about timeframes, the question of how much could be used over a period of time, and spoke consistently about the need for oversight on the part of Congress of the actions of the regulators, and that we wanted Congress to stay and play a role, an oversight role, in the expenditure of these massive amounts of money.

The second thing is this notion that when we talk about participation from outside the industry in paying the bill, there's some notion that that shuts off our involvement or our paying of the cost. The fact is it's an overlay. I think I've looked at it as a situation where we pay the deductible, whatever that number is. We've already paid $3.5 billion and we will continue to pay toward the resolution of this problem even and if and when alternative payment forms come forward. We are not ending our involvement in the settlement of this massive loss that we face.

The CHAIRMAN. Thank you, Mr. Levy.

Mr. Shackelford, go ahead, sir.

STATEMENT OF DONALD SHACKELFORD, CHAIRMAN, STATE SAVINGS BANK, COLUMBUS, OH

Mr. SHACKELFORD. Thank you, Mr. Chairman.

It's a privilege to speak here with a number of the people who are players in the process we are now talking about. I think when it gets to when you lose $50 billion, people get emotional about it. Somebody was calculating yesterday that if you update the dollars for inflation, this is more money than the Marshall Plan. So I guess it's understandable that everybody gets a little bit uptight about it.

If in our testimony we inferred that deregulation was a bad idea, then we perhaps erred in trying to write something jointly. Deregulation of the industry, as Senator Garn pointed out, was, in my judgment, personally, inevitable. Like Mr. Sandler, I am speaking as an individual. Neither Mr. Sandler nor I, for reasons I think will become self-evident, have ever been elected to be a spokesperson of our industry by the people in the industry.

Everybody, I think, during the process of the 1980's probably did something smart and we probably all did something dumb. The big error was uncoupling capital discipline. When you deregulate, you're substituting capital market discipline for rulebook discipline. We inadvertently somehow totally uncoupled capital discipline from risk-asset growth and the need to regulate it.

Former Board Member Hovde I think testified here at one point that a dollar of real or bogus capital could be leveraged 640 times under the net worth 5 year averaging process. When you have a choice of putting in either real capital or bogus capital, people invariably will choose bogus capital. The accounting profession provides such opportunities. Real estate provides some opportunities. Fraud provides some opportunities. Entrepreneurial zeal provided some opportunities. The euphoria that governed about three States—which you're going to find account for most of your loss—Texas, southern California and Florida—created opportunities to do it. And while the search for villains will be understandable and ongoing, to fix the thing you've got to reinsert capital discipline into the process. You cannot grow without real capital in the business. You cannot take on more risk assets without putting real capital in place.

The worst and most egregious cases you will find paraded before the Congress in the next several years' testimony while investigating this—and everybody on a sabbatical in the academic world is writing books about it—the worst cases will have been ones that with hindsight could have been contained. If you were a fraudulent guy sitting down there in Houston, TX, with the worst motives in the world and you've got control of an $80 million institution and yet we kept you from growing beyond $100 million, i.e. we said over 5 years you could only grow from $80 to $100 million because you've got to go get more capital on Wall Street if you want to grow faster. In Wall Street they look at you—they wear suspenders and stuff—and they won't give you the capital to grow unless you answer a lot of very specific questions. If you can't answer, you don't get to grow. The regulators, who are undergoing a great cultural change—can be like Doestoyesky's detective—"I'll get you tomorrow if I can't get you today." Sooner or later, in a plodding way, they caught up—as long as growth is slow.

Regulators have done I think a good job of trying to gear up for deregulation. The technology of even the honest man is moving faster than the regulatory mind can comprehend. What Wall Street is doing out in the open is almost undecipherable to the typical person sitting in Ohio or Illinois or Kansas or someplace. Try to understand risk arbitrage' mismatched funded or hedges. The only guy that's going to make money on that thing in the long run is the salesman, because you can't figure out what you're doing.

We had a fairly simple business, it was taking your mother's money in trust and loaning it to your neighbor's kids to build houses, to build apartments, to buy houses. Because we deferred solving our big problem of interest rate risk so long, there was an understandable need to try to accelerate and diversify asset powers too quickly and catch up too quickly. We've talked about it during the 1970's and got nowhere. In the 1980's we tried to do it all at once and when you do things all at once you end up investing where the assets that are available. They were available in Texas. And if you look at the Texas thrift numbers, they understate the situation because the S&L that has problems in Ohio will have Texas loans, and the S&L's who are closed down in West Virginia have Texas loans. The people in Illinois and Michigan who are in trouble have Texas loans. So whereas the problem can largely be localized in Sunbelt States, and we could find a lot of us to point fingers back and forth at each other, the answer is going to be a very difficult and very costly workout.

CURTAIL GROWTH

Step one is we must curtail growth by all of us who can't put up capital and those who can put up a little bit have got to match our risk asset increases with the increases in capital we can put up. In some places, you find a portfolio that can be worked out by honest people who, say, happen to live in Oklahoma with the collateral blowing back and forth across the road. You can't find a better person to go down from Washington to run that place. Such folk maybe warrant forbearance, if he doesn't grow, if he doesn't open a mortgage loan office in San Diego and Chicago and Miami, he just stays there and cuts the grass in Oklahoma. That was the intent of forbearance.

What we are finding is deals being worked out on forbearance to attract quite speculative capital by people who will take over institutions on a forbearance plan that says you can work without capital for several years. In the marketplace bogus capital, whether it is legitimatized through forbearance or whether it is fraud, always has the same effect. It drives away decent capital which the industry badly needs.

I had concern for this whole recap plan—I was one of the people giving the U.S. League problems—I thought the right number was not $5 billion nor $15, but zero, because you couldn't believe any of the numbers you were being given. Nobody would sit down and talk about how the healthy part of the industry was going to grow its capital into the risk-assets we hold in society funded with your mother's money. We have $38 billion—the S&L's who are allegedly healthy—we've got $38 billion running a risk-asset portfolio of almost $1 trillion. In the next 7 years we've got to grow about double that amount of capital to meet the Federal Home Loan Bank's own 6 percent valid capital standard which we support. To do that, in this competitive market, if that's all we had to do, it's tougher than we've ever been able to do in the past. Our past earnings were in large part based on some quite liberal accounting treatment of fees and things of that nature.

The underlying implicit notion of a recap borne totally by the industry in a lot of this testimony is that there were some greedy guys who are holding back on a surplus of earnings and an excess of capital which if we were more willing we could send down to Dallas to cure the problem. There is no surplus of earnings and there is no surplus of capital. If we are good and lucky and smart, we may be able to grow the capital in the healthy part of the industry up to where it ought to be to justify the risk-assets we acquire in society. If we aren't good and lucky and smart, we won't even get there and somebody in the future will be talking about the problem of why they didn't know what to do with us back in 1988 and asking how come they let us go around and do the stuff we do.

Quite clearly, the Congress will have to address this whole deposit insurance scheme, which most economists think at best doesn't work, and the States are going to have to address their permissive legislation.

[The complete prepared statements of Messrs. Levy, Sandler, and Shackelford follow:]

JOINT STATEMENT OF

GERALD J. LEVY, CHAIRMAN
GUARANTY SAVINGS & LOAN ASSOCIATION, MILWAUKEE, WI.

HERBERT M. SANDLER, CHAIRMAN
WORLD SAVINGS & LOAN ASSOCIATION, OAKLAND, CA.

AND

DONALD B. SHACKELFORD, CHAIRMAN
STATE SAVINGS BANK, COLUMBUS, OH.

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
OF THE UNITED STATES SENATE

AUGUST 2, 1988

Mr. Chairman and members of the Committee, we are pleased to have this opportunity to appear before you today to discuss conditions in the thrift industry and the FSLIC. We are here as three individuals, not as spokespersons for the thrift industry as a whole, nor for any official regulatory body or group or trade association. Our views are our own, although they are in accord with an already large and growing segment of the housing finance industry.

We are all primarily residential mortgage lenders. Our institutions are profitable and have solid real net worth positions. We are proud that our institutions have played a key role in making this the best housed nation in the world. We feel it is essential that thrifts continue to play a vital role in housing finance in the future.

We understand these hearings take place late in the legislative calendar in a busy election year. It is probably unrealistic to expect a major legislative effort in this session. Still, we believe that time is working against us as we struggle with some problems of great financial size and long-run consequence. Therefore, discussing these issues at this time is very important. Further, any actions the Congress can take to encourage constructive regulatory changes to contain the FSLIC problem in the immediate future would be most welcome.

In the detailed discussion which follows, we will state for the record our view of how the thrift industry and the FSLIC got to where it is today. We will not take a great amount of time to emphasize the number of positive steps that have been taken to strengthen the business and the thrift regulatory process. However, in brief, some of the more significant of these positive steps include:

* The Federal Home Loan Bank Board's adoption of rules permitting a viable adjustable rate mortgage which now plays a significant role in housing finance.

* The adoption by the Bank Board of new capital rules which have established a regulatory structure which can relate growth to capital capacity and the ability to bear risks.

* Implementation of new Bank Board regulations limiting the direct investment activities of thrifts and tying such activities to increased capital requirements.

* Establishing more realistic and competitive salary schedules for regulatory personnel throughout the FHLBank System to facilitate recruiting. This change also involved reassigning reporting authority of examiners to the district Banks and shifting examination personnel out of civil service status and pay scales. Reportedly personnel are brighter and better as a result, albeit less experienced. The business strongly supported this move and willingly pays the costs of the higher salaries and of the additional personnel.

* Development of a better training system for examination and supervisory personnel. New guidelines have been developed which will better inform and better coordinate the activities of these essential functions.

- More and improved district Federal Home Loan Bank participation in numerous areas. For example, several district Banks have developed and installed much improved management information systems and an examination peer review system.

In sum, a lot has been done in the 1980s to improve thrift viability and the supervisory-examination process. As a result, today's more than 2,000 healthy thrifts continue to play a major role in housing finance. In order to continue to do so, however, thrifts will need to improve their capital positions, and avoid excessive risk taking.

On the other hand, there have been some very serious mistakes made during the deregulation process of the past few years. At the time, it may not have been apparent or even possible to realize that these actions or the lack thereof would turn out to be so disastrous. Indeed, in some instances, the actions taken represented an attempt to resolve earlier problems that had arisen during the deregulation process. Nevertheless, and with some benefit from hindsight, the following mistakes are a major part of the reason that we are here today discussing a crisis at the FSLIC. These will be discussed in detail later, but include:

MISTAKE #1: THE DEREGULATION PROCESS OF THE EARLY 1980s WAS NOT WELL THOUGHT OUT AND WAS PURSUED ON AN AD HOC BASIS WITH ABYSMAL TIMING. AS A RESULT, IT CREATED A HUGE COST WHICH WAS BORNE ENTIRELY BY THE THRIFT INDUSTRY.

MISTAKE #2: BY THE END OF 1981, VIRTUALLY ALL CAPITAL DISCIPLINE HAD BEEN REMOVED FROM THE THRIFT BUSINESS. NEW CAPITAL-GROWTH REGULATIONS WERE NOT ADOPTED UNTIL JANUARY 1, 1985.

MISTAKE #3: THRIFT LENDING AUTHORITIES WERE EXPANDED TOO QUICKLY IN 1982 AND 1983 GIVEN THE REMOVAL OF VIRTUALLY ALL CAPITAL DISCIPLINE FROM THE BUSINESS AND THE BOARD'S INSUFFICIENT SUPERVISORY AND EXAMINATION RESOURCES. STATE LEGISLATORS AND REGULATORS EXACERBATED THE PROBLEM BY GRANTING ALMOST UNLIMITED AUTHORITIES.

MISTAKE #4: IT BECAME TOO EASY FOR UNDESIRABLE ACQUIRERS, ATTRACTED BY THE LURE OF VASTLY EXPANDED POWERS, TO START OR GAIN CONTROL OF THRIFT INSTITUTIONS, PUTTING UP LITTLE REAL CAPITAL IN THE PROCESS AND EXHIBITING A PROPENSITY TO ENGAGE IN SELF-DEALING AND OTHER QUESTIONABLE PRACTICES.

MISTAKE #5: THE OFFICE OF MANAGEMENT AND BUDGET OPPOSED EFFORTS TO INCREASE THE BANK BOARD EXAMINATION STAFF IN 1983 AND 1984 EVEN THOUGH THE COST OF SUCH STAFF (SALARIES, ETC.) WAS TO BE PAID BY THE THRIFT INDUSTRY.

MISTAKE #6: THE BANK BOARD MADE LITTLE USE OF ITS BROAD AND DISCRETIONARY SAFETY AND SOUNDNESS AUTHORITY IN THE EARLY 1980s TO PREVENT EXCESSIVE GROWTH AND TO RESPOND TO OTHER EARLY WARNING SIGNS OF POTENTIAL THRIFT INSTITUTION FAILURES.

MISTAKE #7: THE BANK BOARD DID NOT ENFORCE ITS OWN 1985 NET WORTH AND MAXIMUM GROWTH REGULATIONS AND FAILED TO ADOPT OTHER NEW REGULATIONS DESPITE STRONG INDUSTRY SUPPORT OF THE NEED TO DO SO AND AS A RESULT DID NOT CONTAIN THE PROBLEMS FACING THE FSLIC.

Over the past several years, numerous thrift executives including those testifying today have been very vocal in their insistence that the regulators limit the risk exposure of the FSLIC and that Bank Board regulations be enforced. In a very real sense, we feel this is extraordinary. It is not often that private firms actually seek stronger regulations and demand tougher enforcement.

How big is the problem facing the FSLIC today? As our later testimony details, we see the problem as very large and growing rapidly. At this point, our best estimate, on an extremely conservative basis, is that resolving the FSLIC problem will cost at the very least $50 billion. It is estimated that the resulting operating losses (excluding writedowns and new problems) of the insolvent institutions are ranging between $500 million and $1 billion per month.

Regulatory mistakes played a very significant role in the development of today's enormous FSLIC problem. Mismanagement, fraud and abuse also played a role. Of course, the significant deterioration in the real estate markets of the Southwest during recent years simply exacerbated the situation. So did the fundamental change in tax laws relating to real estate investments.

Although the Bank Board may not have had sufficient resources to solve the FSLIC problem, it has had significant resources available to it over the past three years. The FSLIC ended fiscal 1984 with $6.9 billion in reserves. In the period of 1985 to 1987, the thrift business has supplied an additional $5.5 billion in regular and special assessments. Of course, the FSLIC has also long been able to write FSLIC notes and enter into assistance agreements. These resources totaling more than $12 billion during the past three years were sufficient so that the Bank Board could have effectively contained the FSLIC problem.

More importantly, the FSLIC has always had the power to limit the activities of thrifts not meeting their capital requirements. It can also replace management and issue cease and desist orders. In sum, it has had the substantial powers necessary to control and limit FSLIC problems even if it did not have the resources to clean them all up.

What immediate actions must be taken to deal with the continuing buildup of the enormous problem facing the FSLIC? We will list them briefly now and discuss them further later. They include:

ACTION #1: FACE UP TO THE REAL SIZE OF THE FSLIC PROBLEM AND ACKNOWLEDGE IT TO THE CONGRESS.

ACTION #2: RECOGNIZE THAT HEALTHY THRIFTS CANNOT AND SHOULD NOT BEAR ALL THE BURDEN OF SOLVING THE FSLIC PROBLEM.

ACTION #3: IMMEDIATELY STOP CREATING FSLIC DEBT AND GUARANTEES IN EXCESS OF THE AMOUNTS AUTHORIZED BY CONGRESS AND WHOSE COSTS CANNOT BE PAID BY THE FSLIC NOR HEALTHY THRIFTS. (EXPLICIT U.S. TREASURY GUARANTEE OF FSLIC DEBTS WOULD ELIMINATE THIS PROBLEM).

ACTION #4: IMMEDIATELY STOP IMPERILING THE FINANCIAL VIABILITY AND CREDIBILITY OF THE 12 FHLBANKS THROUGH BACKDOOR GUARANTEES OR PURCHASES OF EXTRA FSLIC PAPER AND THROUGH LOANS TO THOSE WHO MAY NEVER BE ABLE TO REPAY. (EXPLICIT U.S. TREASURY GUARANTEES OF FSLIC OBLIGATIONS WOULD ELIMINATE THIS PROBLEM).

ACTION #5: REMOVE MANAGERS, BOARDS OF DIRECTORS, STOCKHOLDERS AND SUBORDINATED DEBT HOLDERS OF INSOLVENT THRIFTS IN PREPARATION FOR A MAJOR LIQUIDATION EFFORT IN EARLY 1989.

ACTION #6: ENFORCE THE BOARD'S NET WORTH AND GROWTH RULES BY FORCING INSOLVENT INSTITUTIONS TO SHRINK, LOW-NET-WORTH INSTITUTIONS TO SIGNIFICANTLY LIMIT THEIR GROWTH AND BY LIMITING THE NUMBER OF HEALTHY INSTITUTIONS GROWING VERY RAPIDLY.

ACTION #7: LIMIT THE ACTIVITIES OF WEAKLY CAPITALIZED THRIFTS TO RESIDENTIAL MORTGAGE FINANCE AND CAREFULLY MONITOR PRODUCT DESIGN AND PRICING.

ACTION #8: PROHIBIT WEAKLY CAPITALIZED THRIFTS FROM BIDDING ON AND/OR ACQUIRING WEAK OR INSOLVENT THRIFTS.

ACTION #9: WHEN CAPITAL FORBEARANCES ARE ISSUED, THEY SHOULD PROHIBIT GROWTH AND REQUIRE THAT THE THRIFT LIMIT ITS ACTIVITIES TO RESIDENTIAL MORTGAGE FINANCE.

ACTION #10: DELEGATE AUTHORITY, WITH APPROPRIATE BANK BOARD GUIDELINES, TO THE DISTRICT FEDERAL HOME LOAN BANKS TO RESOLVE FSLIC CASES WITH UP TO $500 MILLION IN LIABILITIES OR WITH A RESOLUTION COST OF UP TO $50 MILLION.

ACTION #11: REQUIRE ALL CAPITAL CONTRIBUTIONS TO BE IN CASH OR CONVERTED TO CASH.

ACTION #12: TIGHTEN THE REGULATIONS SO THAT LOANS TO ANY ONE BORROWER CANNOT EXCEED THE GREATER OF 25% OF GAAP CAPITAL OR $500,000.

ACTION #13: LIMIT THRIFT INVESTMENTS IN MORTGAGE DERIVATIVES, PARTICULARLY, THOSE MADE BY WEAKLY CAPITALIZED FIRMS.

ACTION #14: LIMIT THE USE OF JUNK BONDS, ESPECIALLY BY WEAKLY CAPITALIZED THRIFTS.

ACTION #15: REQUIRE IMPROVED REPORTING AND MONITORING OF INTEREST RATE RISK WITHIN THE THRIFT INDUSTRY.

If we accomplish nothing else with our appearance here today, we hope that you will encourage the Bank Board to take these immediate remedial actions which are essential if the losses facing the FSLIC are to be contained. We also hope that you will agree with us that the more than 2,000 healthy thrifts operating across the nation today continue to serve a vital role in the housing finance system. The thrift system can be fixed and doing so will be of great benefit not only to America's home buyers and savers, but also, to all of those associated with housing today.

HOW WE GOT HERE

For 50 years after it was established in the early 1930s, deposit insurance and the financial institution system worked remarkably well. Bank runs and panics, which had been commonplace in the nineteenth and early twentieth century, became a thing of the past. The savings institution system, dedicated to home finance, was able to provide the funds to satisfy the huge postwar pent-up demand for housing and made America among the best-housed countries in the world.

MISTAKE #1: THE DEREGULATION PROCESS OF THE EARLY 1980s WAS NOT WELL THOUGHT OUT AND WAS PURSUED ON AN AD HOC BASIS WITH ABYSMAL TIMING. AS A RESULT, IT CREATED A HUGE COST WHICH WAS BORNE ENTIRELY BY THE THRIFT INDUSTRY.

The soundness of the system was posited on two very simple assumptions: relatively stable economic conditions (particularly, stable interest rates) and tight controls on what institutions could pay for deposits and what activities they could engage in.

In the inflationary conditions of the 1970s following the Vietnam war and the oil embargo, the first of these conditions disappeared. The resulting high open-market interest rates made the controlled rates paid by financial institutions uncompetitive with those paid by unregulated entities such as money market mutual funds. Small savers complained about not receiving competitive rates of interest from their local financial institutions.

The result was a call for deregulation, for lifting the controls which were seen as making insured financial institutions uncompetitive. The time was ripe for such a call; deregulation fever was in the air. Academic observers had always decried as inefficient the regulated framework under which financial institutions operated. Other industries, such as the airlines and trucking, were also being freed from government supervision and regulation.

As a result, starting in mid-1978, the process of lifting controls on what institutions could pay for deposits was begun. However, the consequences of deregulation -- how deposit insurance might work in a deregulated environment -- was not thought out, the process was pursued on an ad hoc basis, and the timing was abysmal.

Outside of its bad timing, the deregulation process had three major flaws:

1. By law, savings institutions were required to hold the bulk of their assets in long-term, fixed-rate assets which were funded by short-term deposits. Lifting the ceilings on deposit rates and tying them to open-market interest rates meant that the operating costs of savings institutions were tied to the short-term movement of interest rates while their income changed very slowly.

   What should have been done was to allow savings institutions the authority to make variable rate mortgages several years before the deposit side of their structure was deregulated (since it takes several years to turn over a mortgage portfolio). Instead, the exact opposite to what was needed was done, with the deposit side being deregulated several years before the asset side.

The repeated requests of the thrift industry for authority to make viable adjustable rate mortgages and thus create viable assets for a deregulated environment were turned back due to housing industry and consumer opposition in Congress.

2. The regulatory system was not beefed up to handle the new situation. Private-sector institutions should not be allowed to use the government's seal without some restraints. Prior to 1978 these restraints consisted of a combination of curtailing activities that could be engaged in and monitoring closely what institutions did. If the restrictions on powers were to be largely eliminated, then a bigger burden would be placed on the examination and supervisory system to ensure that insured institutions were not using their broader powers unwisely. This was all the more necessary since increased technological capabilities and evolving markets enhanced the ability of market participants to shift financial assets around with great rapidity and to develop new and exotic products.

   But there were no provisions made for the necessary beefing up to the oversight system. In fact, such a buildup was actively opposed by the OMB.

3. Some of the pitfalls inherent in the above two mistakes were magnified by the fact that the real capital in the business was very low. The role of capital is not only to act as a safety cushion to creditors, it also constrains the buildup of risk asset portfolios. The capacity for a financial firm to take on additional risky assets is supposed to run into a limit based on the capital ratio that is either required by the marketplace or -- in a regulated industry such as thrifts or commercial banking -- mandated by regulators.

In the late 1970s, thrifts had capital that, with hindsight, was probably barely adequate for the risks they were taking if conditions did not radically change. But conditions did change and the timing couldn't have been worse.

In late 1979, the Federal Reserve, under great domestic and international pressure to take a stronger stand against inflation, suddenly stopped trying to manage interest rates and concentrated on controlling the money supply instead. It was a radical, and ultimately successful, move. But the price was astronomically high interest rates for several years. Savings institutions suffered hemorrhaging operating losses and much of the real capital of the business bled away.

In December 1980 the industry had assets of $582 billion with a capital base (calculated by tangible capital assumptions) of $32.2 billion. Losses in the years that followed the interest rate revolution reduced thrift industry tangible net worth to a low of $3.8 billion by December 1982.

In sum, the ad hoc and badly bungled deregulation process of 1980 to 1982 was incredibly costly for the thrift business. It reduced industry capital by more than $28 billion. As a result, many thrifts entered 1983 greatly overleveraged and in a desperate need of earnings.

MISTAKE #2: BY THE END OF 1981, VIRTUALLY ALL CAPITAL DISCIPLINE HAD BEEN REMOVED FROM THE THRIFT BUSINESS. NEW CAPITAL-GROWTH REGULATIONS WERE NOT ADOPTED UNTIL JANUARY 1, 1985.

If an industry cannot meet a regulatory standard due to economic stress, one possible response is to lower the standard. This was the response of the Bank Board to the strains imposed by the deregulation process. The Federal Home Loan Bank Board under Chairman Jay Janis asked Congress to give it authority to vary the capital requirement of the business between 3% and 6% of deposits. In October 1980, the Bank Board used the new authority granted it under the Depository Institutions Deregulation Act of 1980 to reduce thrift capital requirements to 4% of liabilities. The Bank Board also removed the so-called Asset Composition and Net Worth Index which was an early effort to construct risk-related capital requirements.

The process of relaxing capital discipline in the thrift industry was continued under Bank Board Chairman Richard Pratt. In 1981, the Bank Board reduced the capital requirement of the business to 3% of deposits. The Board also specifically retained an old five-year averaging provision which, when coupled with the lowering of the nominal requirement to 3%, had the extraordinary result of requiring really less than 1% capital support for new assets in institutions growing rapidly -- and the way averaging worked was that the more rapid the growth rate, the lower the effective required capital support. Put another way, the 3% requirement and the five-year averaging meant that a dollar of capital (whether real or phantom) could be leveraged into more than six hundred dollars of risk assets.

Further, for newly chartered institutions, a 25-year phase-in rule was retained in their minimum capital requirement which gave these firms, even when they had virtually no net worth, the ability to grow rapidly and remain in capital compliance.

Of course, in 1981-82 the Bank Board was operating in a crisis atmosphere. Eighty percent of the nation's thrifts was losing money. The FSLIC had many more problems than it could deal with using its limited staff and resources.

This crisis atmosphere led the Bank Board to take actions to buy time for interest rates to decline. For instance, the Board eased accounting rules (e.g. it allowed institutions to sell below-market loans with the resulting loss being written off over a period of years rather than being recognized immediately) and actively promoted a loophole in GAAP accounting relating to the creation of goodwill in acquisitions. Frankly, this was done so that the Board could employ the vaporous incentive of allowing institutions to use the loophole to artifically boost reported income to encourage them to take problem cases off the FSLIC's hands. As a result, the credibility of thrift accounting was seriously damaged and an era of questionable accounting policies was spawned. (The Financial Accounting Standards Board, "FASB", acted to close this purchase accounting loophole in January 1983.)

The Bank Board under Chairman Gray began its efforts to re-institute capital discipline in the thrift business in early 1984. On February 15, 1984, the Bank Board proposed new net worth requirements which would have reaffirmed the 3%-of-deposits capital requirement and eliminated five-year averaging with some phase-out provisions. A vocal minority of thrift executives supported Chairman Gray. Still, thrift trade groups and many industry executives successfully opposed this proposal and asked that they be reproposed at a later date in a different form.

During late 1984, the Bank Board once again proposed new net worth requirements for the thrift business. By this time, with growing evidence of serious problems developing among a number of "high-fliers", an overwhelming part of the thrift business supported new capital requirements. On January 31, 1985 the Bank Board adopted new capital requirements tied to growth, with those growing at an annual rate in excess of 25% over a six-month period required to obtain special supervisory approval.

The removal of capital discipline and the delay in its reinstatement led to significant losses for the FSLIC. Thrift trade groups and many (not all) thrift executives must share the responsibility for these actions. But, ultimately, the industry cannot be expected to be its own regulator -- and under anti-trust laws, is probably not allowed to be -- so the thrift regulators who did not act to protect the safety and soundness of the thrift system must bear the brunt of the responsibility.

MISTAKE #3: THRIFT LENDING AUTHORITIES WERE EXPANDED TOO QUICKLY IN 1982 AND 1983 GIVEN THE REMOVAL OF VIRTUALLY ALL CAPITAL DISCIPLINE FROM THE BUSINESS AND THE BOARD'S INSUFFICIENT SUPERVISORY AND EXAMINATION RESOURCES. STATE LEGISLATORS AND REGULATORS EXACERBATED THE PROBLEM BY GRANTING ALMOST UNLIMITED AUTHORITIES.

As the liability-side deregulation process continued, it became obvious that thrifts had to have the ability to hold adjustable rate mortgages and shorter maturity assets if they were going to be viable. The Bank Board responded by taking numerous actions. A most helpful, though overdue, action was the authorization, finally, to make truly viable ARMs in April 1981. However, other actions, such as the elimination of all maximum loan-to-value ratios (August 1981) and the repeal of restrictions on using brokers to channel deposits to the most aggressive bidders for funds (March 1982), were to prove disastrous subsequently.

In October 1982, the Congress also tried to "help" out the thrift business with the passage of the Garn-St Germain Act which granted savings institutions the authority to invest in a broader range of assets. The Bank Board moved swiftly to implement the authorities granted in the Garn-St Germain Act, authorizing consumer loans up to 30% of assets, expanding the power to invest in commercial real estate loans to 40% of assets, and authorizing unsecured loans for commercial purposes.

In retrospect, it is obvious that the most risky of these actions was the combination of greatly expanded real estate authorities and the removal of loan-to-value ratio requirements. This made it possible for thrifts to make 100% loans on land held for development, speculative condominium projects and commercial real estate while front-ending substantial fees to boost income. This situation was compounded by the Bank Board's inadequate supervisory and examination system, by the removal of both capital and accounting discipline from the thrift business, and by the removal of the limits on the use of brokered deposits.

Not to be outdone by their federal counterparts, state legislatures and regulators acted to significantly increase thrift powers. In several instances, these new state authorities went far beyond those granted to federal institutions. Thus, a competition in laxity of regulation and supervision developed between state and federal thrift regulators.

By late 1983, the Bank Board and many in the business began to realize that the mixture of broad powers and no capital discipline could lead to big problems for the FSLIC. Efforts to regain control of the situation after it had acted too liberally became quite a struggle. For example, in late 1983, the Board under Chairman Gray made public its concerns about the use of brokered deposits and the rapid growth they made possible. In March 1984, the Bank Board acted to deny FSLIC insurance to brokered deposits.

The industry as a whole supported Chairman Gray's efforts although a few firms objected vehemently. The Securities Industry Association, however, strongly opposed the Bank Board's action and sued in federal district court -- only one of many instances in which Wall Street used the deregulation process for huge gains at the expense of the thrift business and the FSLIC. On June 10, 1984, the federal court ruled that the Bank Board's brokered deposits regulation exceeded its authority. Subsequently, the Bank Board withdrew its regulations.

As mentioned before, the Bank Board adopted new capital requirements tied to growth on January 31, 1985. Similarly, during early 1984, the Bank Board also became aware of the problems that were developing involving direct investments. A few thrifts had well-publicized problems with high risk and unusual investments in such things as ski resorts, water parks, fast food chains, gambling casinos, stud and windmill farms. They also had experienced some difficulties as direct investors in land development projects and some building activities.

In May 1984, the Federal Home Loan Bank Board proposed regulations which would limit direct investments by thrift institutions. Although most of the business supported Bank Board efforts to limit direct investments, the few in opposition generated considerable political heat. The Bank Board and the Congress held hearings. The institutions involved in these activities vehemently opposed any limitations on thrift direct investments.

This political battle delayed the Board's efforts and led it to repropose its direct investment limitations in December 1984. The Bank Board's direct investment regulation was finally issued on January 31, 1985 and became effective in March 1985. Even when it did become effective, however, the Board's regulation did not include land loans, speculative condominium loans and nonresidential construction loans with very high loan-to-value ratios. (Such an expansion in the direct investments regulation did take place in July 1987.)

Along with direct investments, thrifts became more heavily involved in what became known as "ADC loans". These were acquisition, development, and construction "loans" that had many of the characteristics usually associated with a direct or equity investment. Usually, these "loans" involved loan-to-value ratios of 100% or more, giving the borrower virtually no assets at risk in the project.

Because ADC loans were treated as loans instead of investments, lenders were able to charge substantial up-front fees and use them for an immediate income boost. Early delinquencies were avoided as lenders structured these deals so that the first two or three years of interest payments, plus the up-front fees, were also included in the original "loan". This postponed accounting recognition of loan losses.

The accounting community, the American Institute of Certified Public Accountants (AICPA) and FASB, did not address the issue of whether these ADC financings were loans or investments for some time. The AICPA did issue an initial "Notice to Practitioners" concerning such financial transactions in November 1983 and a second notice was issued in November 1984.

Still, even these actions by the AICPA did not provide sufficient guidance as far as thrift ADC lending was concerned. In April 1985, the Bank Board adopted a regulatory policy dealing with the accounting treatment of thrift ADC activity.

By acting too liberally and too rapidly to expand thrift powers, the Bank Board allowed special interest groups to develop, whose goal was to perpetuate certain risky activities. Delays caused by these powerful interest groups in the area of direct investments and ADC loans together with the outright failure to curb the use of brokered funds created significant losses for the FSLIC.

MISTAKE #4: IT BECAME TOO EASY FOR UNDESIRABLE ACQUIRERS, ATTRACTED BY THE LURE OF VASTLY EXPANDED POWERS, TO START OR GAIN CONTROL OF THRIFT INSTITUTIONS, PUTTING UP LITTLE REAL CAPITAL IN THE PROCESS AND EXHIBITING A PROPENSITY TO ENGAGE IN SELF-DEALING AND OTHER QUESTIONABLE PRACTICES.

Another factor which compounded the situation in the early 1980s relates, once again, to the Bank Board's response to the need of the FSLIC to resolve problem cases. For example, the Board allowed new investors willing to acquire problem institutions to do so with little new capital and much of that in the form of real estate or other assets. The ability to contribute raw land on the basis of an appraisal instead of cash was particularly appealing to developers and other non-traditional thrift acquirers. The Board proposed regulations in late 1983 requiring capital contributions to be in cash but never adopted or reproposed such a measure.

The Bank Board also was very liberal with respect to its powers under the Change in Savings and Loan Control Act of 1978. Instead of carefully screening acquirers, the Board rarely contested such acquisitions. In 1981, there were 42 notices of changes in control submitted to the Board and none were disapproved. Again in 1983, the Board did not disapprove any of the 108 such notices filed.

The Federal Home Loan Bank Board is required by the Change in Control Act to report on its experience with it each year. In what must constitute one of the most egregious examples ever of blindness and inattention to a major emerging problem, in its annual reports from 1981 through 1984 (the latter report being issued at the end of August 1985 when widespread problems had to be already apparent), the Board used, verbatim, the same boilerplate language each year:

> "The savings and loan industry remains predominantly mutual, rather than stock in organization, consequently FSLIC administration of the Act has generally been uneventful. ... The figures would appear to reveal that the Act has had far less impact on acquisitions of control in the savings and loan industry than in the commercial banking industry, where Federal regulators have received hundreds of formal notices. ... Post-acquisition experience has been generally unexceptional."

It was not until its 1985 annual report (issued in July 1986) that the Bank Board showed any alarm as to the acquisition of savings institutions by unscrupulous individuals:

> "It has been the Bank Board's experience that the perceived attractiveness of thrifts unfortunately also has led to efforts by financially weak or unstable companies and unqualified and dishonest individuals to acquire and exploit thrift institutions. As a result, substantive as well as procedural weaknesses in the regulations implementing the Control Act too often have been abused, in some cases leaving the FSLIC to pay the price for such shortcomings."

By the time of this expression of concern, of course, billions of dollars in damage had already been done to the FSLIC because of the regulatory laxity in policing acquisitions.

The Pratt Board also made it much easier to gain control of a thrift charter in other ways. For years, it was required that a thrift have a minimum of 400 stockholders. No one individual was allowed to own more than 25% of an institution's stock. By removing these restrictions, the Board made it possible for entrepreneurs to invest modest sums with few if any partners and start or acquire control of a thrift institution.

The vast new powers of the thrift charter, the ease with which control could be obtained, and the modest capital required were all promoted by the Bank Board in the investment community. This may have reduced the FSLIC's resolution costs in the early 1980s but, in retrospect, it also significantly increased FSLIC's risk and loss exposure for the future which ultimately resulted in substantial additional losses.

MISTAKE #5: THE OFFICE OF MANAGEMENT AND BUDGET OPPOSED EFFORTS TO INCREASE THE BANK BOARD EXAMINATION STAFF IN 1983 AND 1984 EVEN THOUGH THE COST OF SUCH STAFF (SALARIES, ETC.) WAS TO BE PAID BY THE THRIFT INDUSTRY.

Although thrift powers were expanded and the capital discipline in the business was removed, not much was done to expand the Bank Board's supervisory and examination staff. In fact, on May 5, 1983, the Bank Board in testimony before the Senate Appropriations Committee requested 38 fewer field examiners for fiscal 1984 than in fiscal 1983.

By 1984, however, the Bank Board recognized that its examination and supervision staff was totally inadequate. The Bank Board repeatedly asked the Office of Management and Budget for authority to hire new examiners and supervisors in 1984 and early 1985. These requests were just as repeatedly denied by the OMB.

There was widespread support in the industry for the Bank Board's request for more people. The business recognized that it would have to pay for these additional people but realized that the long-term savings derived from better supervision and examination was well worth the price. To this day, we cannot understand the OMB's costly opposition to these requests.

In June 1985, the Bank Board acted on its own and transferred the thrift examination function to the district Federal Home Loan Banks and, thus, freed them from OMB limitations. The Board immediately increased examiner compensation, reduced personnel turnover, and began to add new people. In the second half of 1985, the number of examiners in the system increased 35% from 747 in June to 1,006 by December. During 1986, the combined examination and supervisory personnel of the Federal Home Loan Bank System rose 55% to 2,074.

The OMB's singleminded opposition in this area significantly delayed the Bank Board's efforts to improve the quantity and quality of thrift supervisory and examination personnel. In turn, this delay was very costly to the FSLIC as the inadequacies in the system went uncorrected.

MISTAKE #6: THE BANK BOARD MADE LITTLE USE OF ITS BROAD AND DISCRETIONARY SAFETY AND SOUNDNESS AUTHORITY IN THE EARLY 1980s TO PREVENT EXCESSIVE GROWTH AND TO RESPOND TO OTHER EARLY WARNING SIGNS OF POTENTIAL THRIFT INSTITUTION FAILURES.

As the thrift industry entered 1984, it was obvious that the stage was set for significant problems to develop. The removal of capital discipline had led to rapid growth in many institutions. Many new operators had entered the business and made it clear they planned to exploit the situation by taking advantage of the expanded thrift powers and the ability to become highly leveraged. The Bank Board's supervisory and examination system was clearly not up to the task of dealing with these challenges.

In retrospect, it is clear that the safety of the thrift system and the continued viability of the FSLIC depended upon the willingness of the Bank Board to act quickly and to use its broad discretionary powers to protect safety and soundness and its ability to reinstitute capital and accounting discipline. Unfortunately, the Board was notably unsuccessful in both of these vital areas. As a result, many in the business complained that there was no sense of urgency at the Board or in the examination and supervisory process. The limited resources of the Bank System were not targeted to areas of obvious abuse but simply continued to operate as if things were normal.

The weak nature of the supervisory and examination operation of the Bank Board is further reflected by a general lack of enforcement. The Board did not use its temporary cease-and-desist (C & D) powers to stop unsafe and unsound activities. In 1983, the Board issued only 17 C & D orders. This number decreased to 13 such orders in 1984, before it increased to 28 in 1985. Almost all of these C & D orders were issued with the consent or voluntary approval of the institutions involved.

The use of the Bank Board's power to remove individuals from institutions was also used sparingly. In 1983, the Board removed 21 individuals from institutions while 22 were removed in 1984 and again in 1985.

Formal investigations were also relatively small in number. The Office of Enforcement held 17 such investigations in 1983 and 24 in 1984. In 1985, there were 30 formal investigations.

The number of supervisory agreements did increase sharply over this time period. In 1983, only 39 such agreements were completed. The number of supervisory agreements totaled 116 in 1984 and then increased further to 233 in 1985. Unfortunately, this less forceful approach by the Bank Board led to frequent delays and much circumventing and, in some cases, violations of these agreements.

Perhaps the clearest indication of the Bank Board's unwillingness to act in time in a discretionary way to protect the system is documented in Congressional hearings into the failure of two institutions -- Empire Savings and Loan of Mesquite, Texas and Beverly Hills Savings and Loan Association.

Empire Savings was closed on March 14, 1984 when it had $308.9 million in deposits. Less than two years earlier on June 30, 1982, this institution had only $17.3 million in deposits. The fact that the Bank Board allowed this institution to pursue such a reckless growth pattern is only one of the many aspects of regulatory and supervisory neglect surrounding the failure of Empire Savings.

On August 6, 1984, the Committee on Government Operations of the House of Representatives issued its report on the failure of Empire Savings and its evaluation of the Bank Board's supervision of the institution. Among the report's most significant findings were the following:

* "The FHLBB's failure to take strong administrative and enforcement action against Empire and its principals between late 1982, when it first learned of the association's abusive practices, and late 1983, when it first took effective action, represents an instance of significant regulatory neglect."

* "Although the Bank Board's regular supervisory examination of Empire as of October 7, 1982, disclosed 'significant examination factors rated as either material deficiencies or requiring immediate forceful supervision action,' no effective supervisory action was taken by the FHLBB until late 1983. There was failure at every supervisory level."

* "The FHLBB knew a great deal about Empire's growing financial morass early in 1983 but it did virtually nothing to enforce its extensive supervisory and regulatory powers until quite late in 1983."

These findings lead to a number of significant recommendations including:

* "There should be immediate onsite evaluation of institutions exhibiting excessive growth or significant adverse changes from past performances."

* "The Office of Examinations and Supervision should institute a system to monitor excessive growth."

* "The FHLBB allows problems in regulated thrifts to drift because the Board does not have a uniform schedule of sanctions and a timetable for imposing them. In order to remedy this, supervision of problem thrifts should be increased by requiring the imposition of a predetermined schedule of supervisory actions."

- "The FHLBB should take steps to improve its early warning system based on computerized data supplied to it on a regular basis to alert it to potential problems. More attention needs to be paid to alert examiners and supervisory personnel to special problems which the data may disclose to adversely rated thrifts. The Bank Board in Washington should more closely monitor the manner in which regional supervisory offices utilize the information made available."

The 1984 findings and recommendations of the Committee on Government Operations are extremely important even though more than four years have passed since they were made. So is the fact that many of the Committee's recommendations were not implemented during the years that followed. It should have been an embarrassment to the Bank Board that the Congress had to make such basic recommendations and is disturbing that many similar recommendations could still be made today.

Another example of the Bank Board's failure to act came to light with the failure and investigation of Beverly Hills Savings and Loan Association which was closed on April 23, 1985. As was the case with Empire Savings, this institution experienced incredible growth. At the end of 1981, Beverly Hills Savings had assets of $611 million. Three years later at the end of 1984, its assets totaled $2.8 billion. More than $1.0 billion of its 1984 assets were in direct investments, ADC (acquisition, development and construction) loans and noninvestment grade bonds.

During June of 1985, the House Subcommittee on Oversight and Investigations of The Committee on Energy and Commerce held hearings concerning the collapse of Beverly Hills Savings. During those hearings a number of important facts surfaced including:

- In the April 30, 1982 examination report of Beverly Hills an examiner wrote "The association has operated at a loss for each of the past 17 months. . . .If the trend continues net worth will be depleted by November 1983."

- Beverly Hills Savings and Loan received an adverse rating of "3-C" as a result of the April 30, 1982 examination and as a result of the February 25, 1983 examination. The "3-C" was given when there were material deficiencies in a series of nine different areas.

- On March 25, 1983 a FHLBB memo reviewing the 1983 operating plan of Beverly Hills stated that: "Historically, the association's business plans have been very optimistic and of limited usefulness in monitoring the association's operations. It remains to be seen whether the subject 1983 business plan will prove to be an exception."

- In a July 12, 1984 internal memorandum involving the supervision of Beverly Hills Savings and its request to accept brokered deposits, the supervisor noted that as of May 31, 1984 Beverly Hills Savings had regulatory net worth equal to 2.0% of its total liabilities and was subject to regulatory limitations.

- Despite numerous problems over a number of years going back to early 1982, Beverly Hills Savings was allowed to grow rapidly and was not placed into the Bank Board's Management Consignment Program until April 1985.

The supervisory neglect associated with the rapid growth and failure of Beverly Hills Savings was a lot like that involving Empire Savings of Mesquite, Texas. In retrospect, it is clear that these were not isolated instances but instead provided a clear indication of the significant problems the Bank Board was having in dealing with the deregulated environment.

MISTAKE #7: THE BANK BOARD DID NOT ENFORCE ITS OWN 1985 NET WORTH AND MAXIMUM GROWTH REGULATIONS AND FAILED TO ADOPT OTHER NEW REGULATIONS DESPITE STRONG INDUSTRY SUPPORT OF THE NEED TO DO SO AND AS A RESULT DID NOT CONTAIN THE PROBLEMS FACING THE FSLIC.

As the business entered late 1985, it became clear that the issue of funding the FSLIC had to be addressed. The Federal Home Loan Bank Board had begun charging a special FSLIC assessment in early 1985. The Chairman of the Federal Home Loan Bank Board also insisted that the FSLIC had to be recapitalized through a large infusion of cash from the industry.

During late 1985, the U.S. League of Savings Institutions created a special committee which it called the "Task Force on FSLIC Issues" to study this question and make recommendations. (Gerald Levy was Chairman of this Task Force while Herbert Sandler and Donald Shackelford were members.) The first thing the Task Force reviewed was the Bank Board's efforts to contain the problems facing the FSLIC.

Given the new net worth rules put in place in January 1985 and the direct investment limitations of March 1985, the Task Force expected to find that the Bank Board's supervisory and examination staff had the situation under control. Unfortunately, data for the first half of 1985 showed this was not the case. For example, the Task Force found that 443 institutions with assets of $103.7 billion grew at an annual rate of more than 25% over the first six months of 1985.

Under the Bank Board's growth regulations, institutions were required to obtain specific supervisory approval to grow at an annual rate of 25% or more in a six month period. Some exceptions to the 25% maximum rule could be expected but not over 400. Further, the Task Force discovered that many of these rapid growers were heavy investors in high risk assets, often had very high goodwill ratios, and tended to be big users of brokered deposits.

Representatives of the Task Force met with Chairman Gray to express their concerns over the seeming inability of the Bank Board to regain control of the situation and over the continuation of past supervisory and enforcement inadequacies. Meetings were also held with representatives of the Dallas Federal Home Loan Bank because of the Task Force's special concerns about conditions in that district.

The Task Force was particularly concerned about 45 institutions with more than $500 million in assets that grew at an annual rate of more than 25% in the first half of 1985. Indeed, history shows that this concern was justified. As shown in Exhibit 1, twenty of these institutions had negative tangible GAAP equity as of March 31, 1988. The tangible capital of these institutions fell from a negative $65 million at year-end 1984, to a negative $279 million at the end of June 1985. By March 1988, this negative equity hole had widened to a negative $5.9 billion.

EXHIBIT 1

FAST GROWERS IN THE PAST ARE MAJOR PROBLEMS TODAY

(DOLLARS IN MILLIONS)

Institution Name	Location	Tangible Capital as of March 1988	Liab. as of March 1988	GAAP Capital As of March 1988	Annualized Asset Growth 1st half of 1985	Tangible Capital as of Dec. '84	Tan Cap As as Dec
Sunbelt SA of Texas	Dallas, TX	-$1,699	$4,042	-$1,696	202%	-$13	-0.
Independent American[1]	Irving, TX	-699	1,635	-696	63%	-67	-5.
American Diversified[2]	Lodi, CA	-656	1,166	-656	27%	27	3.
University SA	Houston, TX	-623	4,232	90	26%	87	2.
Bright Banc SA	Dallas, TX	-562	4,795	-232	519%	33	5.
Commodore Savings	Dallas, TX	-435	1,151	-433	55%	12	2.
Security S & LA	Scottsdale, AZ	-291	1,076	-291	44%	-48	-5.
Sandia FS & LA	Albuquerque, NM	-287	1,308	-216	90%	-41	-6.
United SA of Texas	Houston, TX	-188	4,928	37	27%	-50	-1.
Commonwealth Savings	Houston, TX	-179	1,933	-172	52%	34	3.
Meritor Savings Bank[3]	Arlington, VA	-51	718	60	489%	-40	-15.
Blue Valley FS & LA	Kansas City, MO	-38	931	-38	27%	15	1.
Champion FS & LA[4]	Bloomington, IL	-37	2,399	77	54%	-88	-6.
First FS & LA	Austin, TX	-31	1,004	-18	84%	42	7.
Murray Savings	Dallas, TX	-26	1,436	-14	81%	30	4.
Allenpark Federal[5]	Houston, TX	-24	234	-24	62%	6	0.
Occidental FSB	Omaha, NE	-22	730	-17	79%	8	1.
Montfort Federal[6]	Dallas, TX	-13	1,222	-13	27%	30	3.
Charter FS & LA	Bristol, VA	-2	868	53	85%	-21	-4.
Altus Bank, A FSB[7]	Mobile, AL	-0	2,567	97	44%	-21	-1.
Totals/Averages		-$5,864	$38,377	-$4,104	73%	-$65	-0.

[1] Placed in the MCP in May 1987.

[2] Liquidated by FSLIC in June 1988. Had been an MCP.

[3] Old name was Northern Virginia S&L.

[4] Old name was Bloomington Federal.

[5] Placed in the MCP April 1986. Old name was Mainland Savings.

[6] Old name was Vernon Savings which was made an MCP in March 1987. Montfort Savings, its successor MCP, was created in November 1987.

[7] Old name was First Southern Federal.

How some of these institutions managed to grow so rapidly is not understandable. Nine of the 20 had negative tangible equity at the end of 1984 -- before they even embarked on their rapid growth. The deterioration of some of these institutions is frightening. Consider:

* Sunbelt Savings in Texas at year-end 1984 had liabilities of $1.3 billion with a negative $13 million in tangible capital. By March 1988, its liabilities stood at $4.0 billion with a tangible capital of negative $1.7 billion.

* Bright Banc of Dallas, through ordinary growth and mergers, increased in size from $488 million at year-end 1984 to $4.8 billion at the end of March 1988. Over the same period, its tangible capital fell from a positive $33 million to a negative $562 million.

* American Diversified in California was placed in the Bank Board's Management Consignment Program in February 1986. It was recently liquidated by the FSLIC at a cost of $1.14 billion.

* Montfort Savings is a newly-chartered institution which took over the remains of the failed Vernon Savings. Vernon Savings grew from $871 million to nearly $2 billion at its peak. It became an MCP in March 1987, and its deposits were transferred to Montfort Savings in November 1987 at a cost to FSLIC of $1.2 billion. The problem of Vernon Savings has still not been completely resolved.

The Task Force made it clear to the Bank Board that the healthy, well run institutions in the business could not be asked to recapitalize the FSLIC at the same time as several institutions were allowed to continue to run rampant. Task Force members were shocked and outraged that the healthy savings institutions were not only being asked to pay to resolve problems they did not create, they were asked to do so while it was obvious that little was being done, even then, to keep the problem from getting bigger. Unless tight controls were placed on these institutions, the Board was asking for a blank check on the industry's already far too weak capital position.

Chairman Gray responded to the Task Force with a promise that the Bank Board would act immediately to ensure that the problems facing the FSLIC were contained and that risks of future added costs would be minimized. He asked the Task Force to accept his pledge in this regard and to move ahead and develop a plan to recapitalize the FSLIC using industry and Bank System resources.

In March of 1986, the Task Force On FSLIC Issues put forth its plan for recapitalization of the FSLIC. The second paragraph on the first page of that report entitled, "A Comprehensive Strategic Plan For The FSLIC" states:

> "The first thing that must be done is to stop new problems from developing. The Federal Home Loan Bank Board, under Chairman Edwin Gray, had done a number of things which should help, including implementing new net worth, direct investment and de novo institution regulations; beefing up the supervisory system; moving the examinations staff out of Washington, D.C.; and creating a new Office of Enforcement at the Bank Board. Even with these strong measures in place, still more must be done."

The Task Force report goes on to call for the Bank Board's supervisory and examination staff to adopt an "instant response" mode. Also recommended was the development of a new problem targeting system, the creation of a National Special Strike Force of supervisory agents, more delegation to principal supervisory agents, a review of the Change of Control Act and tightening of the loans-to-one-borrower regulations. Significantly, the Task Force went on to recommend that the Management Consignment Program institutions (MCPs) and Phoenix institutions should be operated in a shrinkage mode. (Many of these same recommendations had been made to the Board repeatedly by individual thrifts at earlier points in time.)

The Bank Board did respond by initiating an immediate and wide-ranging examination of Texas savings institutions. It did not, however, follow up with an organized plan to contain the situation until FSLIC recapitalization legislation could be passed. The fact that the Board did not put a halt to the growth problem, even after new capital/growth regulations were adopted in January 1985 and Chairman Gray's promise of late 1985, can be seen from various statistics:

1. In most quarters from the beginning of 1985 to the first quarter of 1987, between 400 and 500 institutions grew at an annual rate exceeding 25%.

2. In the first quarter of 1985, there were 49 GAAP insolvent thrifts growing at an annual rate of more than 25%. This number subsequently declined to a low of 19 but, as of the first quarter of 1988, was back up to 38. There is a similar pattern of institutions growing at annual rates of between 10% and 25%, with the number of insolvent institutions growing at these relatively rapid rates standing at 112 in the first quarter of 1988.

   Looking at this in another way, 37% of GAAP insolvent institutions were shrinking in size in the first quarter of 1985. Three years later, only 33% of the 501 GAAP insolvent thrifts were shrinking. Obviously, there has been a notable lack of progress.

3. When industry representatives met with Chairman Gray in late 1985, they not only complained about a lack of control over the FSLIC problem in general, but also indicated their special concern about growth in the Dallas Federal Home Loan Bank District. The energy problems in the Southwest were apparent at this point as was the potential for overbuilding. The business stressed that growth had to be controlled in the Southwest if the costs to the FSLIC were going to be manageable.

   During the first quarter of 1985, 42 of the 132 Texas thrift institutions that are now insolvent were growing at an annual rate of more than 25% (Exhibit 2). At that stage, quite a number of the 132 institutions were still solvent and, in fact, 48 reported GAAP capital in excess of 3%.

   By the first quarter of 1988, when all 132 were insolvent, 16 were still growing at more than a 25% annual rate, up from a low of 10 in the fourth quarter of 1986. Thus, even as their capital positions declined, many of these now insolvent thrifts were allowed to grow at a rapid rate.

EXHIBIT 2: INSOLVENT TEXAS THRIFTS GREW RAPIDILY IN THE PAST AND CONTINUE TO DO SO TODAY...

	Annualized Liability Growth				
Date	Under 0%	0%-10%	10%-25%	Over 25%	Total
12/84 to 3/85	32	29	28	42	131
3/85 to 6/85	25	34	27	46	132
6/85 to 9/85	34	28	29	41	132
9/85 to 12/85	49	31	25	27	132
12/85 to 3/86	32	25	40	34	131
3/86 to 6/86	46	35	26	24	131
6/86 to 9/86	47	33	29	23	132
9/86 to 12/86	71	30	21	10	132
12/86 to 3/87	51	36	27	18	132
3/87 to 6/87	49	28	38	17	132
6/87 to 9/87	51	43	25	13	132
9/87 to 12/87	29	50	41	12	132
12/87 to 3/88	26	43	47	16	132

Note: Only 131 institutions are listed for the period of 12/84 to 3/85 because Park Cities Savings Association was a De Novo institution in March of 1985. Only 131 institutions are listed for the periods 12/85 to 3/86 and 3/86 to 6/86 because information for Mainland Savings Association, an MCP, was not released in March 1986.

On the other hand, the percentage of this group actually shrinking was lower in the first quarter of 1988 than it was during the first quarter of 1985. In other words, when most of these 132 thrifts had positive GAAP net worth, 24% decided to shrink their asset position. When most were insolvent during the first quarter of 1988, the Bank Board required only 20% to shrink and allowed the remainder to grow.

Of all the mistakes we have discussed, the failure to contain the problem since it became widely recognized in 1985 is probably the most inexcusable and the least understood by those outside the business. During the past few years, the overwhelming majority of thrifts have repeatedly asked for stronger and swifter supervisory action by the Bank Board. Had those requests been heeded and acted upon, the size of the problem facing the FSLIC today would be lower by many billions of dollars.

INDIVIDUAL INSTITUTION CASE STUDIES: A FAILURE OF SUPERVISION

The fact that the Bank Board did not contain the FSLIC problem is also reflected by numerous individual institution experiences resulting in significant losses. The largest of these case studies involves the Bank Board's direct supervision of Financial Corporation of America (FCA).

During the early 1980s, FCA was the holding company for State Savings and Loan Association of Stockton, CA. At the end of 1980, State Savings had total assets of $1.7 billion. Over the high interest rate period of the next few years, State Savings of Stockton grew rapidly, with its total assets reaching $3.7 billion at the end of 1981 and increasing further to $5.8 billion at the close of 1982. Given the rapid growth of State Savings and its strong reported earnings during this difficult period, many people in the business questioned its asset quality. It was a common staple of conversation that "trash for cash" deals were being solicited by its loan officers. Many healthy thrifts repeatedly warned supervisory personnel of the dangers posed by State Savings. They were often told that they were just jealous of their new aggressive competitors.

State Savings of Stockton continued to expand rapidly in 1983 and had assets totaling $10.2 billion by August of that year. At this point, the Bank Board approved FCA's acquisition of First Charter Financial Corporation and its subsidiary American Savings. The resulting savings institution subsidiary of FCA took the name American Savings.

First Charter Financial Corporation was a very healthy institution -- "a model of the old-style thrift, with a wealth of stable, low-cost deposits gathered from a widespread branch system, a high capital-asset ratio, and conservative lending practices," according to the Wall Street Journal. As a result of this merger, FCA put $1.2 billion of goodwill on its books while it increased its total asset holdings to $21.6 billion as of December 31, 1983. Just one year earlier, on December 31, 1982, the company reported total assets of only $5.8 billion. -- it might be noted that the institution had only $645 million in total assets five years earlier, at the end of 1977.

When the industry continued to complain about FCA's excessive growth and the Bank Board's approval of the First Charter acquisition, it was told that the situation was under control. The new FCA was going to manage its growth and meet new, higher capital requirements. Still, by June 1984, FCA's assets had reached $31.4 billion, an increase of $10 billion in just six months. It never reached the new net worth requirements established in its 1983 merger.

At this point, many thrifts complained about FCA's use of questionable accounting techniques. On August 15, 1984, FCA bowed to pressure from the SEC and restated its second quarter earnings to show a second quarter loss of $107.5 million instead of an earlier reported profit of $31.1 million. Soon, a run developed and the Bank Board was forced to act. The decision was made that FCA was simply too large to put into liquidation. The Board replaced FCA's management and announced its strong support for the new operation of American Savings.

The Bank Board did not, however, eliminate the interests of FCA's stockholders and subordinated debt holders. The resulting conflict between FCA's obligation to its stockholders and the fact that it was a ward of the FSLIC probably led to some of the management mistakes which followed. Permitting stockholders to keep their interests in FCA was a major blunder.

Shortly after taking over, FCA's new management announced its plans to shrink the institution. As a result, FCA's assets peaked in the third quarter of 1984 at $32.5 billion. By year's end, the company's assets had fallen to $28.5 billion.

In early 1985, FCA announced that it would further reduce its assets by 18%. By December 31, 1985, FCA's assets had fallen to $27.4 billion. It did not reach its targeted shrinkage size of $24.5 billion, but it was clearly going in that direction. The firm control of the Bank Board as it approved FCA's quarterly operating plan and the strong supervisory control maintained by the Federal Home Loan Bank of San Francisco continued through the first quarter of 1986. The company ended the quarter with $26.4 billion of assets and $6.6 billion in mortgage-backed securities. At this point, it seemed clear that the management approach at FCA was aimed at shrinkage and minimizing the exposure of the FSLIC to additional losses.

All of this changed in the second quarter of 1986 as it became clear that FCA had adopted a new operating strategy. First, direct supervision of FCA was taken away from the Federal Home Loan Bank of San Francisco and transferred to Washington, D.C. The San Francisco supervisors had objected to FCA's new growth strategy proposal. Then, with Bank Board approval, FCA began the rapid acquisition of MBSs using reverse repurchase agreements (reverse repos) as a funding source. The resulting interest rate risk exposure was supposed to be offset by various hedging activities. Over the second and third quarters of 1986, the company added $10 billion in MBSs to its portfolio, increasing its MBS holding to 49% of its total assets. Over the same period, FCA's reverse repos went from $4.9 billion to $11.9 billion.

In general, the business responded with sharp criticism as FCA adopted this new strategy. It was pointed out that FCA was a very weak institution under direct Bank Board supervision. The proper course for such a company was to reduce its size, minimize its interest rate risk exposure, and if possible, liquidate its MBS portfolio while interest rates were low. It did not seem appropriate for the Board to allow FCA to adopt a highly risky position which could cost the FSLIC and, thus, the business, billions of dollars.

The business was also very concerned over the Bank Board's removal of direct supervision of FCA from the district Bank to Washington, D.C. It was not viewed as appropriate for the Bank Board to directly involve itself in the management of one institution. Further, removing existing supervision created a dangerous precedent which has been followed all too recently.

The Bank Board ignored industry criticism and approved the new FCA operating strategy. By doing so, the Board took a gamble on interest rates very similar to that it had so vocally denounced in the past. If interest rates stayed low, as FCA hoped, the institution's stockholders would benefit. If interest rates increased, the FSLIC would end up taking the losses.

The argument was made that if FCA won its bet, the FSLIC would also win because it would have one less problem case. However, the same holds true for any FSLIC-insured institution. In this case, the Bank Board was simply blinded to its function as insurer due to its direct role in the supervision and operation of FCA. As a result, it approved one of the largest interest rate bets by a financial institution in history.

At the end of 1984, when the Bank Board's management team was in control and reporting quarterly, the company held mortgage loans totaling $19.5 billion and MBSs of $5.3 billion. If the Bank Board had continued its shrinkage policies of 1985 and sold off its MBS portfolio, FCA would have ended 1986 with a mortgage loan portfolio totaling $12.6 billion and total assets of roughly $17 billion.

Further, it should be noted that when the Board put its own management into FCA, and provided that it must approve FCA's operations on a quarterly basis, the Bank Board greatly increased its direct responsibility for FCA's management. For a very weak institution to gain direct Bank Board approval to acquire $10 billion in MBSs in a period of six months and fund these new long-term assets with reverse repos defies belief.

At the end of 1986, FCA held MBSs totaling $17.4 billion. The reported market value of these holdings was $17.1 billion for a loss of $0.3 billion at year-end 1986. By the end of 1987, the company's MBS portfolio had increased to $18.2 billion but its market value had declined to only $16.6 billion. Thus, FCA's loss on its MBS holdings had increased to $1.6 billion by year-end 1987.

In early 1988, the new Bank Board under Chairman Wall ordered FCA to reduce its MBS holdings by $2.5 billion. Management of the institution complied under protest. The Bank Board also said it would like FCA to trim its MBS portfolio by a total of $12 billion by the end of 1988. Obviously, the new Board recognizes the risk such a portfolio represents for the FSLIC while FCA's stockholders also realize they have an interest in betting on interest rates.

Even the head of FCA, William Popejoy, has admitted the risk inherent in the institution's MBS portfolio. In a recent article in the American Banker (July 26, 1988), Mr. Popejoy is quoted as saying that:

> "The mortgage-backed securities portfolio, totaling about half of American's assets, represents a considerable interest rate risk. The portfolio is only partially hedged, and the hedges are expiring."

By the end of March 1988, FCA's holdings of MBSs had declined to $16.0 billion. The company reported a negative equity position of $227 million and goodwill of $980 million, creating a negative tangible net worth position of -$1.2 billion as of March 31, 1988.

Unfortunately, the supervisory errors made with FCA were not an isolated case. Numerous other examples can now be seen. Consider the following:

(1) Lyons Federal Trust and Savings Bank in Illinois was founded in 1922. By the middle of 1981, it still had assets of only $73 million. But by the time it was taken over by regulators in 1987, it had ballooned in size to $2.2 billion, a growth of about 3,000% in six years. At the same time, the institution invested these proceeds in many risky ventures which had been turned down by other lenders, such as a 100,000 square foot wharfside development project in South Florida. Lyons was even reported to have entered into a contract to buy 40,000 Hyundai personal computers which the institution intended to resell to other savings institutions throughout the country -- the success of this venture depended on every institution in the nation purchasing an average of over 12 each of a questionable brand of computer.

For years, thrift executives in the Chicago area had warned that Lyons was headed for disaster and that it would represent a major cost to the FSLIC. In May 1984, three and one-half years before Lyons officially failed, Crain's Chicago Business, a local business weekly, ran a major front-page story detailing Lyons' risky strategies -- its rapid growth, speculative lending and low capital position. At that time, the institution's assets were listed at $1.3 billion, almost $1 billion less than they would be when the institution failed.

Similarly, on August 20, 1985, the American Banker reported that "competitors -- and reportedly regulators -- have griped about Lyons' rapid growth." If people in the industry and the press knew about the situation, why didn't the regulators know or, if they did, why didn't they step in to stop the continued rapid growth and risky investments made by this institution? In the same story, Barbara Miller, Lyons' president at the time, is reported to have said "We're not afraid to make mistakes." Unfortunately, even though the industry complained for years about resulting strategy at Lyons, it is nevertheless now being required to pay for the cleanup.

(2) American Diversified Savings Bank of Costa Mesa, CA was formed in June 1983 by the merger of Tokay Savings of Lodi, CA, a $10.9 million institution as of December 1982, and a development company owned by Ranbir S. Sahni. In two years, it grew to more than $1 billion in assets with over 95% of their funding coming in the form of brokered deposits. With the help of 20 subsidiaries, American Diversified Savings Bank formed limited partnerships to buy real estate in enterprises such as: two ethanol plants, three wind farms, a contract to collect manure for a planned co-generation facility, a national paging system and a cable-TV system for its apartment complexes and other properties located in 22 states.

When Chairman Gray began preaching about the evils of deregulation and often cited the example of an institution that invested in wind farms, American's president decided to change its philosophy and undertake a more traditional path than it had in earlier years. The institution successfully argued to Bank Board officials that they needed additional expansion to make this new philosophy work. Chief among the Bank Board's concessions was an agreement to let American grow at 25% per year.

On February 14, 1986, American Diversified was declared insolvent and seized by the FHLBB. Pacific Savings Bank agreed to operate American under a management contract. Mr. Sahni, Chairman, and Lester Day, President, were terminated as officers of the institution but were allowed to remain as directors and shareholders, holding 96% and 4% respectively. The seizure was prompted by an audit that revealed:

** Many of American's loans were based on "inadequate or inflated appraisals."
** American failed to file reports with state and federal authorities "in a timely manner".
** American failed to establish loan loss reserves required by the regulators.

On June 6, 1988 federal regulators announced a record $1.14 billion payout to depositors of American Diversified Savings Bank. It had lost $21.5 million in the first quarter of 1988. Because of its lack of retail offices, the FSLIC had been unsuccessful in finding a buyer.

(3) Sunrise Savings & Loan of Boyton Beach, FL was founded by Richard Foxman, an attorney, in 1980. Mr. Foxman believed that a new thrift could be profitable if it were part of a network that could switch funds from one section of the country to another, engage in joint ventures with other network thrifts and broker loans too big for any one of the network members. Said Foxman, "We will create our own secondary mortgage market." The institution opened with assets of $4 million and reached $1.5 billion in assets five years later.

On April 25, 1985, CEO Bob Jacoby and two EVPs of Sunrise were reportedly forced out by regulators. On May 15, 1985, Sunrise reported a loss of $24.6 million for its fiscal quarter ended March 31. Nonperforming loans had ballooned to $85.7 million or 5.7% of assets compared to $44.8 million or 3.2% of assets six months earlier. Nine months earlier nonperforming loans totaled $11 million or 1% of assets.

In its filings with the SEC for the quarter ending 3/31/85, Sunrise revealed it was operating under a three-year supervisory agreement with the regulators in addition to an agreement reached the prior year. Under the new agreement, it could not grow by more than "25%" per year, it had to reduce its acquisition, development and construction (ADC) loans from 40% to 20% of its total loan portfolio and it could not make loans for land purchases that exceeded 95% of the purchase price.

The FHLBB seized control of Sunrise on July 18, 1985, and placed it under management contract with Amerifirst Federal Savings of Miami, Florida. It was declared insolvent due to poor underwriting practices, high risk direct investments and acquisition, development and construction (ADC) loans that went sour. Many of these ADC projects were in areas that were not developed but expected to grow; thus when the real estate market bottomed out in late 1984, Sunrise was forced to file a lot of foreclosures. CEO Jacoby maintained that Sunrise's ADC loans were not risky because developers pledged their personal wealth.

On September 13, 1986, the FHLBB announced the closing of Sunrise Savings. The FSLIC filed suit in Miami Federal Court seeking $250 million in damages from 27 former directors and officers and the former general counsel of Sunrise. Allegations of director wrongdoing included:

** Failing to require that appraisals be performed by reputable appraisers rather than by the borrower.
** Allowing a five-man committee to approve loans of over $1 million after April 1984 when a Supervisory Agreement required the full board to approve any loan over $500,000.
** Establishing an internal "audit committee" that failed to implement internal controls and relied on management's representations of compliance.
** Undertaking or participating in over 100 unsafe or unsound transactions.

(4) FirstSouth Federal Association of Pine Bluff, Arkansas aggressively sought local deposits, offering rates 100 basis points higher than its competitors. These funds were mainly used to book direct real estate investments located in the Texas area. Its assets grew from $360 million in June 1982 to $1.8 billion by December 1985.

FirstSouth regularly disregarded restrictions on insider loans. Its March 1986 examination revealed:

** The 13 largest borrower-stockholders with 49.9% control received more than $612 million in insider loans representing 36% of total assets and 45% of total commercial loans.

** Loan underwriting reviews showed that these insider loans were made largely to provide 100%-plus financing for speculative land purchases based on inflated appraisals.

** As of February 28, 1986, $465 million of commercial loans were secured by undeveloped real estate.

By December 4, 1986, FirstSouth was closed and its insured deposits and some assets were transferred to the newly-chartered Riverside Savings and Loan. J. Paul Johnson, executive director of the Arkansas League, said that the closing of FirstSouth did not come as a shock to him or his organization's membership because it had been reporting losses and several top officials had resigned. Johnson said: "Everyone anticipated FirstSouth needed assistance of some kind. Its problems and loan losses were common knowledge."

In May 1987, the FSLIC filed a $300 million lawsuit against the former chairman, Mr. Wiechern, and the Board of Directors claiming that the Board deferred completely to the former chairman and allowed him to exercise unbridled discretion in FirstSouth's operation. Allegations against former chairman Wiechern were that he unilaterally approved loans and gave money to favored borrowers before consulting FirstSouth's loan and credit approval committees. The FSLIC said that he "disregarded the financial interest of FirstSouth in favor of those of certain friends, associates and favored borrowers." On several occasions, FirstSouth exceeded regulatory limits on the amounts that could be loaned to one borrower and, at one time, had $126 million in loans to two of its stockholders. In December 1987, the FSLIC merged Riverside Savings and Loan with Home Savings Association of Kansas City, Missouri.

HOW BAD IS THE SITUATION FACING THE FSLIC?

At present, there is a significant difference of opinion concerning the probable costs facing the FSLIC if it is going to clean up the problem of failed thrifts. Exhibit 3 shows a list of some of the more recent estimates of the size of the FSLIC problem. The lowest of the publicly stated estimates seems to be that of Federal Home Loan Bank Board Chairman Wall. In his most recent testimony before the House, he projected the size of the FSLIC's problem at $30 billion with $15 billion needed for Texas alone. Just six weeks earlier, on May 26th before this Committee, he presented projections estimating the cost of resolving the FSLIC problem at $22.7 billion.

At the other extreme are such outside observers as Bert Ely, an industry consultant, and Dan Brumbaugh, a former Federal Home Loan Bank Board economist. Mr. Ely's latest estimate of the FSLIC problem stands at $64 billion (New York Times 7/9/88). Mr. Brumbaugh's current estimate of the cost the FSLIC faces is $75 billion (Los Angeles Times 6/13/88).

Exhibit 3 also shows the number of insolvent thrifts measured on a RAP, GAAP and tangible capital basis as of March 31, 1988. Depending on the definition of insolvency used, the tangible equity (i.e. GAAP equity minus goodwill) of insolvent institutions ranges between -$26.3 billion and -$33.6 billion. It also must be borne in mind that delayed recognition incorporated into any accounting system means that some losses incurred in the past are still unreported.

Given these data, we must agree with those who argue that Chairman Wall's estimate of the problem is too low. Moreover, it is highly likely that there are further losses to be taken by some already insolvent thrifts. There will also be some insolvencies that have not yet been recognized. Finally, to fully resolve these problem cases and create healthy thrifts, the FSLIC will have to provide more assistance than is reflected by the tangible capital position of these insolvent institutions.

EXHIBIT 3: ESTIMATES OF THE SIZE OF THE FSLIC PROBLEM VARY WIDELY...

Chairman Dan Wall:	$30 billion
Bert Ely:	$64 billion
Dan Brumbaugh:	$75 billion

NUMBER OF INSOLVENT THRIFTS BY DIFFERENT MEASURES, MARCH 31, 1988

	RAP Insolvent	GAAP Insolvent	Tangible GAAP Insolvent
Number	367	501	659
Total Liabilities	$158.2 billion	$199.2 billion	$361.3 billion
RAP Capital	-$20.4 billion	-$19.5 billion	-$12.2 billion
GAAP Capital	-$23.0 billion	-$23.7 billion	-$17.7 billion
Tangible GAAP Capital	-$26.3 billion	-$28.0 billion	-$33.6 billion

In our view, placing a *precise* number on the size of the FSLIC problem is not the central issue. Still, our best estimate given the information shown in Exhibit 3 is that the FSLIC is now facing, on an extremely conservative basis, at the very least a $50 billion problem. We do not even agree among ourselves concerning the full magnitude of what the FSLIC is facing; our individual estimates range from $50 billion up to perhaps $75 billion or even $80 billion.

We all do agree, however, that it is essential that we recognize and face up to the full magnitude of the FSLIC problems. Further, we know that whatever the real size of the problem, it is extremely large. It is larger than the entire net worth of the viable part of the industry. Also, the potential costs of dealing with the problems facing the FSLIC have been increasing at a very rapid rate. Currently, insolvent thrifts are running up operating losses at an annual rate of $6.4 billion. This does not include write-downs or losses due to additional failures. This means that every month that a solution is delayed, the cost increases by *over* $500 million -- and some would say, the real number is more like $750 million to $1 billion. The seriousness of the situation can be judged when these *monthly* losses are put in the context of the *annual* regular FSLIC premium the thrift business pays, currently about $800 million.

Exhibit 4 shows how the equity deficit of insolvent thrifts has been growing over the last three years. At the end of the first quarter of 1985, there were 458 GAAP insolvent thrifts. Their liabilities totaled $112.8 billion and their GAAP equity equaled -$3.7 billion.

Conditions deteriorated over the next 12 months but not rapidly. By the end of the first quarter of 1986, the number of GAAP insolvent thrifts had declined to 450 institutions. The total liabilities of these insolvent institutions had increased minimally to $113.8 billion. Their GAAP equity had deteriorated further, however, and stood at -$5.9 billion.

During the next year, the GAAP equity position of these GAAP insolvent institutions dropped sharply, reaching -$12.2 billion at the end of the first quarter of 1987. The number of insolvent thrifts increased only modestly, however, reaching 465 while their total liabilities also increased, to $128.2 billion as of March 31, 1987.

Since then, the situation facing the FSLIC has deteriorated significantly. The number of GAAP insolvent thrifts increased by 36 and now stands at 501. The liabilities of these insolvent institutions have increased 55% and now total $199 billion. Most importantly, the negative GAAP equity position of these GAAP insolvent thrifts is now twice as bad and stands at -$23.7 billion.

As noted earlier, even this GAAP equity measure probably understates the situation. On a tangible GAAP basis there were 659 insolvent thrifts at the end of March 1988. The tangible GAAP equity of these insolvent companies was -$33.6 billion at the end of the first quarter of this year.

EXHIBIT 4: THE LOSSES OF GAAP INSOLVENT THRIFTS HAVE GROWN RAPIDLY...

Date	Number of GAAP Insolvent Thrifts	GAAP Net Worth of GAAP Insolvent Thrifts	Liabilities of GAAP Insolvent Thrifts
3/85	458	-$3.7	$112.8
6/85	466	-3.9	123.3
9/85	468	-4.5	125.6
12/85	461	-5.3	127.5
3/86	450	-5.9	113.8
6/86	455	-7.2	118.3
9/86	446	-7.9	117.3
12/86	459	-10.4	131.1
3/87	465	-12.2	128.2
6/87	491	-14.3	140.2
9/87	501	-16.8	147.4
12/87	506	-19.1	158.8
3/88	501	-23.7	199.2

Note: GAAP capital is defined as regulatory capital less qualifying mutual capital certificates less qualifying subordinated debt less appraised equity capital less net worth certificates less accrued net worth certificates less income capital certificates less deferred losses (gains) on loans and other assets sold. It was decided to exclude ICCs from GAAP capital even though FASB has determined that ICCs exchanged for cash are part of GAAP. The cash qualifier on the ICCs guided the decision to exclude ICCs since it was not possible to ascertain which ICCs were in fact exchanged for cash.

Of course, the situation has deteriorated most rapidly in the state of Texas. Exhibit 5 shows the worsening situation in that state. Three years ago, at the end of the first quarter of 1985, there were 37 GAAP insolvent thrifts in Texas having total liabilities of $4.7 billion. Their GAAP equity equaled -$190 million. The number of GAAP insolvent thrifts in Texas grew steadily in 1985 but totaled only 51 institutions with liabilities of $10.7 billion at the end of the first quarter of 1986. These insolvent institutions had GAAP equity of -$650 million just two years ago. Since then, however, the number of Texas thrift insolvencies, and more importantly, their negative equity positions have increased rapidly.

One year ago, at the end of the first quarter of 1987, there were 94 insolvent thrifts in Texas having $34.8 billion in liabilities and a GAAP net worth of -$4.6 billion. While the number of insolvent Texas thrifts had increased by only 43 between the first quarters of 1986 and 1987, the capital hole of the Texas GAAP insolvent thrifts increased $3.9 billion. As a group, these thrifts had a GAAP equity to liabilities ratio of -13.2% at the end of the first quarter of 1987.

With the passage of another year, the situation deteriorated at an even more rapid pace. By the end of the first quarter of 1988, there were 132 insolvent thrifts in Texas. Their liabilities totaled $61 billion and their GAAP net worth was -$12.85 billion. Thus, their GAAP equity to liabilities ratio was -21% at the end of March 1988.

How did the situation facing the FSLIC deteriorate so incredibly in just three years time? Clearly, there were several factors which combined to create today's huge problem.

Probably the most obvious of these relates to the deterioration of the real estate market in the Southwest following the boom conditions of the early 1980s. These conditions are well documented and will not be expanded upon here.

A second factor that has been much less recognized was the elimination of various real estate related tax benefits in the Tax Reform Act of 1986. For many years, national tax policy allowed investors to shelter income by investing in various real estate projects. This greatly encouraged building, particularly in the sunbelt region.

When many of these tax benefits were removed, the economics of many real estate projects was altered significantly. In areas having a strong local economy, the market adjustments to this new economic reality as far as many real estate projects were concerned were mitigated by a general increase in property values.

The impact was different in areas where the economy was weak or depressed. Weak and declining property values discouraged marginal investors. Removal of the special tax benefits associated with such properties led such marginal investors to abandon various real estate projects to lenders. Many lenders experienced unexpected losses as depressed conditions and the removal of tax incentives made it difficult and costly to deal with foreclosed properties. In other instances, lenders were forced to restructure real estate financing to minimize losses on properties that otherwise could have been handled without loss.

EXHIBIT 5: THE LOSSES OF GAAP INSOLVENT THRIFTS IN TEXAS HAVE GROWN RAPIDLY IN RECENT YEARS...

Date	Number of GAAP Insolvent Texas Thrifts	GAAP Net Worth of GAAP Insolvent Texas Thrifts	Liabilities of GAAP Insolvent Texas Thrifts
3/85	37	-$0.19	$4.72
6/85	37	-0.26	5.29
9/85	42	-0.31	6.73
12/85	45	-0.44	8.35
3/86	51	-0.65	10.65
6/86	59	-1.29	14.51
9/86	66	-2.05	18.43
12/86	81	-3.36	31.43
3/87	94	-4.59	34.84
6/87	104	-6.20	44.83
9/87	116	-7.78	50.22
12/87	125	-9.15	55.85
3/88	132	-12.85	60.65

Note: GAAP capital is defined as regulatory capital less qualifying mutual capital certificates less qualifying subordinated debt less appraised equity capital less net worth certificates less accrued net worth certificates less income capital certificates less deferred losses (gains) on loans and other assets sold. It was decided to exclude ICCs from GAAP capital even though FASB has determined that ICCs exchanged for cash are part of GAAP. The cash qualifier on the ICCs guided the decision to exclude ICCs since it was not possible to ascertain which ICCs were in fact exchanged for cash.

Still, all the problems of today's insolvent thrifts and the rapi deterioration of their equity positions over the past three years cannot be attributed to depressed real estate conditions and the change in real estate tax laws alone. Instead, these conditions simply exacerbated a situation created by numerous regulatory, supervisory and enforcement delays and mistakes which in turn allowed unscrupulous individuals to engage in self-dealing and, in some cases, fraud.

During 1985, it was already becoming clear that the economy in the Southwest was weak and that the real estate market was beginning to show signs of overbuilding. As outlined earlier, it was also clear that many thrifts were out of control, making highly risky loans, growing too rapidly and utilizing questionable accounting techniques. It is clear, as it has been for some time, that the Federal Home Loan Bank Board did not contain the situation.

If the Bank Board had enforced its capital and growth regulations as adopted in January 1985, the total liabilities of GAAP insolvent thrifts would not have nearly doubled over the past three years. If the Bank Board had forced insolvent thrifts to shrink and prevented weak thrifts from expanding rapidly, the negative GAAP equity position of today's insolvent thrifts would not have increased by $20 billion between March 1985 and March 1988.

Over the three-year period of 1985 to 1987, the thrift industry has paid more than $2 billion in regular FSLIC premiums and another $3.5 billion in special FSLIC assessments (plus, one might add, $7.9 billion in income taxes). After paying more than $5.5 billion in FSLIC assessments, healthy thrifts would have expected the problems facing their insurance fund to have declined. Instead, as a result of the Bank Board's failure to contain the problem and because of the impact of economic and tax factors, the FSLIC faces a problem far beyond its capacity to resolve.

THE CAPITAL POSITION OF HEALTHY INSTITUTIONS

One of our major concerns has been the lack of a strategy to ensure the safety and soundness of the capital structure of the viable portion of the thrift industry. All lenders take risks in our society. The concept of capital in regulatory strategy is to have sufficient cushion to have time to detect and act, and ultimately to bear the probable losses from the risks undertaken.

We believe the capital cushion of the viable portion of the thrift industry should not be further eroded. Instead it needs to be built up. The focus in the last few years has, understandably, been on the insolvent companies. But to neglect for long the buildup of capital of the solvent thrift industry is to neglect the safety and soundness responsibility of regulators. We believe the regulator is getting caught in a conflict between his responsibility as head of FSLIC and his responsibility as regulator of the industry.

As of March 1988, the thrift industry reported total assets of $1,261 billion. But institutions with negative tangible net worth accounted for $349 billion of these assets. That would leave $912 billion in assets for the solvent industry.

The entire savings institution business at the end of March 1988 had tangible capital of $4.6 billion (although this is somewhat of an understatement of the amount of tangible capital since we cannot adjust for deferred discounts which are not reported. These discounts offset goodwill to some extent). The $4.6 billion is arrived at by netting the tangible capital of negative $33.6 billion of the insolvent part of the industry against the solvent segment's positive $38.2 billion.

Thus, the solvent segment of the business, as we have defined it, has assets of $912 billion and tangible capital of $38.2 billion, a capital to assets ratio of 4.2%. The Bank Board has mandated that institutions must have capital of 6% by sometime in the early 1990s. The increase in the ratio is tied to the industry's median return on assets so the exact date the 6% level will be required is unknown, but it will probably be around 1995. We wholeheartedly support this minimum as we have been fervent proponents of increased capital requirements for the business.

If a capital requirement of 6% were the rule today, that would mean that capital should now be $44 billion for the solvent portion of the business rather than the current $38.2 billion. And if the solvent institutions grew at 5% per year for the next several years, this would produce an asset base of $1,283 billion by 1995 for that portion of the business. A 6% capital requirement at that stage would mean that these institutions would need capital of $77 billion.

The projected capital buildup needed is $38.8 billion (from $38.2 billion today to $77 billion in 1995), an average of $5.5 billion per year that must be generated from retained earnings and through newly raised capital or debentures.

Four conclusions seem self-evident:

1. The entire capital of the business today would not solve the FSLIC's real economic problem.

2. A reduction in the capital buildup by the viable industry can lay seeds for problems tomorrow -- the capital of the healthy part of the industry needs to be built, not demolished.

3. There is no surplus capital in the industry to reallocate to the Southwest or elsewhere.

4. Until the business' capital is built up to a prudent level, the industry and its regulators must consider restructuring to reduce risk to fit the capital that exists.

WHAT ACTIONS MUST BE TAKEN IMMEDIATELY?

As we noted earlier, we recognize that there is not time in this legislative year for the Congress to find a way to resolve the FSLIC problem. It is obvious that any solution is going to have a significant impact on the federal budget, and therefore, we would expect the final solution to have complexities aimed at mitigating that budget impact. Further, it is essential that the Congress work with the new administration early next year to address the many larger issues relating to the federal deposit insurance system.

The fact that a final resolution of the FSLIC problem will not take place for many months could significantly increase the ultimate cost of dealing with the problem. As we have told the Bank Board repeatedly, and must reiterate now, it is essential that everything possible be done to contain the FSLIC problem and keep new problems from developing.

In this regard, we have a number of suggestions. We hope you will use your influence to encourage the Bank Board to adopt our suggestions as soon as possible. If something isn't done immediately, we see the situation getting even more out of control. The resulting losses could add many billions of dollars to the ultimate cost of resolving the FSLIC situation.

ACTION #1: FACE UP TO THE REAL SIZE OF THE FSLIC PROBLEM AND ACKNOWLEDGE IT TO THE CONGRESS

At present, the Federal Home Loan Bank Board will not recognize the real magnitude of the problems faced by the FSLIC. The Bank Board has better and more immediate access to the data on the business than anyone else. We do not understand how Chairman Wall can ignore the facts shown in Exhibit 3 and simply maintain its current unrealistic position.

Refusal to face up to the real magnitude of the problem creates many difficulties for policymaking. For example, many of the Board's recent decisions imply a strategy that would bleed the thrift industry dry to solve the FSLIC situation. Aside from the fact that the Board's solution may be approaching a constitutional barrier on the expropriation of private property, the problem, in any case, far exceeds the capacity of the healthy thrifts to handle it. Efforts to bleed thrifts completely of their already insufficient capital would be counterproductive and will only make the situation worse since the process itself would produce additional thrift failures and substantial new FSLIC losses.

Further, if the Board would recognize that the FSLIC problem is too big for it to resolve alone, it could establish containment as a top priority. Far too much time, energy and effort at the Bank Board is being spent trying to find new and inventive ways to stretch resources and hide costs. These efforts could be refocused toward utilizing the resources available more effectively and in a way which helps to stop new problems from developing. The Bank Board could also be spending time developing alternatives for next year's effort to reform the deposit insurance system and to solve the FSLIC problem. Given the way the cost of dealing with the problem is growing, it is essential that the Bank Board help the next administration focus on this issue as an early and top priority.

ACTION #2: RECOGNIZE THAT HEALTHY THRIFTS CANNOT AND SHOULD NOT BEAR ALL THE BURDEN OF SOLVING THE FSLIC PROBLEM

As a result of the Bank Board's refusal to accept the reality of FSLIC's situation, the Board has felt it necessary to publish projections attempting to show that healthy thrifts can shoulder the burden of resolving the problem. In his July 7 testimony before the House Banking Committee, Bank Board Chairman Wall made these projections public. We have a great deal of trouble with the Bank Board's projections not only because they significantly understate the FSLIC problem, but also because they depend upon a set of assumptions that simply cannot be realized simultaneously, particularly if thrifts are going to comply with the Bank Board's own capital and growth regulations.

Let us briefly review some of the key implicit assumptions made by the Bank Board in its most recent projections:

Assumption #1: The Thrift Business Will Grow Rapidly Over The Next Eleven Years

The Bank Board assumes that the total deposits of the thrift industry will increase from $909 billion at the end of fiscal 1987 to $2 trillion at the end of fiscal 1998. This assumes an annual deposit growth rate of 7.2% for all thrift deposits over an 11-year period characterized by relatively stable prices -- if we have high inflation with consequent high interest rates, then we have a whole other problem on our hands. Thus, the Board assumes much faster deposit growth than that of the past three years when, between year-end 1984 and year-end 1987, deposits grew at an annual rate of 5.9%.

In reality, however, the Board assumes much more. Exhibit 6 shows the total deposits at the end of March 1988 for three tangible net worth ranges. If we assume thrifts with no tangible capital do not grow, then this reduces the deposits now eligible for growth to $677 billion. These deposits would have to grow at an annual rate of 8.8% for total deposits to reach $2 trillion in 1998 even when the $281 billion of deposits held by insolvent thrifts are added back in at their current level. In and of itself, this is not a reasonable assumption.

Assumption #2: The Thrift Industry Will Have A Six Percent Capital Ratio By 1998

For the business to have a tangible GAAP capital ratio equal to 6% of assets by 1998 will be very difficult under the best of conditions. At the end of March 1988, the tangible GAAP solvent thrifts had total tangible GAAP capital equal to $38.2 billion. If the business has $2 trillion in deposits in 1998, it will have assets of roughly $2.7 trillion. In order to reach a 6% capital ratio, the business will need $162 billion in capital given that rapid growth. This implies an annual tangible capital growth rate for thrifts of roughly 14.0%. In and of itself, this is not a reasonable assumption.

Assumption #3: No More Thrift Failures Will Occur

The Bank Board's projections assume that there will be no more new failures from now on and that the FSLIC will have resolved all current problems by about 1994. Not many people would believe that scenario even if we could reimpose strict regulation. On the contrary, most would believe that, given just the volatility in the financial markets, there will be ongoing failures of both commercial banks and savings institutions.

On top of that, one of the built-in costs of deregulation is the potential for failure. Many banks and thrifts will try new things given the authority to do so and the potential for profit and some will fail. Further, it is likely that there are failures not yet recognized but already locked in that will come to light in the next several quarters. We also know that, in a number of instances, conditions have been allowed to develop which are likely to result in additional thrift failures. As we stated earlier, the FSLIC problem has not been contained.

It should also be recognized that, in and of itself, the continuation of the special FSLIC assessment is likely to create additional new thrift failures. For example, in 1987:

> The special assessment caused the business in three states -- Alabama, Florida and Mississippi -- to report a combined loss last year instead of a combined profit in the absence of the special assessment;
>
> Of the 876 unprofitable institutions, 67 would have shown a profit in the absence of the special assessment.

Further, the extra cost of the FSLIC special assessment comes at a time when all financial institutions face declining margins and greatly increased competition. As a result, both savings institutions and commercial banks are doing everything they can to reduce their operating costs and build capital. The extraordinary assessments being paid by FSLIC today places them at a severe competitive disadvantage as they seek to minimize their operating costs. In sum, it is not reasonable to assume no new thrift failures in today's deregulated financial environment.

Assumption #4: The FSLIC, With No Reserves, Can Backstop A $2.7 Trillion Business

The Bank Board's numbers assume that the FSLIC will spend just about all of its income over the next 11 years in the resolution of cases and in paying interest on the obligations it is building up. Because of this, the FSLIC will not be adding anything to its reserves and, therefore, having started out essentially insolvent, it will still be insolvent 11 years from now.

This will mean that, even if we were to grant the unlikely assumption that the FSLIC can solve the current massive problem it faces, the problem of the FSLIC would still be with us and its bankrupt status would remain an ongoing story in the media -- it will be like a persistent fever in the American financial system.

The Board's numbers assume that, in the meantime, the industry will grow to $2.7 trillion. It is not reasonable to assume that the FSLIC, with no reserves, can backstop a business of this size.

Assumption #5: Strong Thrifts Will Not Leave The FSLIC Between Now And 1998

We do not believe that the Congress will elect to build a permanent "Berlin Wall" around the thrift business so that healthy institutions can be prevented from leaving the FSLIC between now and 1998. This would amount to the virtual confiscation of the real capital now present in the business. Even if such an attempt were made, however, loopholes would be sure to develop. For that matter some strong institutions might feel forced to self-liquidate and distribute the realized surplus to their shareholders in preference to having it confiscated.

Further, a long-term "Berlin Wall" strategy would be self-defeating. The quickest way to raise capital levels is through conversion to the stock form of organization in the case of a mutual or through issuing additional shares of stock in the case of a stock institution. But as long as the capital of the industry is subject to confiscation or threat of confiscation, then investors will be leery of putting capital in the business. In other words, the "Berlin Wall" will not only keep thrifts in but also keep investors out.

This depresses the price of all savings institution shares. With the shares of healthy institutions depressed, why should investors go through the headaches and risks of recapitalizing risky institutions when they can buy the shares of healthy institutions at depressed prices in the marketplace? This is, indeed, one of the reasons for the underwhelming lack of demand for troubled savings institutions being marketed by the Board in its Southwest plan.

Finally, even if the federal government was determined to confiscate the entire capital of the thrift industry, it would not solve the FSLIC problem but instead make it worse. Exhibit 6 shows that the tangible GAAP capital of the thrifts insolvent on a tangible capital basis equaled -$33.6 billion as of March 31, 1988. The total tangible capital of the solvent thrifts was only +$38.2 at the end of March 1988. As we noted previously, just bringing the capital of today's insolvent thrifts up to zero will not solve the problem. Even this limited goal, however, would leave today's healthy institutions without capital. In turn, this means the entire $1.3 trillion thrift industry would become a FSLIC problem.

It is simply not reasonable to assume that the Congress will attempt to build a "Berlin Wall" around the thrift industry and pursue the self-defeating course of confiscating the capital of today's healthy thrifts.

Assumption #6: It Is Fair To Ask Today's Healthy Thrifts To Shoulder All The Burden Of Resolving The FSLIC Problem

The real magnitude of the costs facing the FSLIC and the contradictory nature of the assumptions underlying the Bank Board's projections (which means they can't be realized) makes it clear that healthy thrifts cannot pay the whole cost of resolving this problem. In fact, if healthy thrifts are going to rebuild their greatly depleted capital base, they cannot continue to pay today's special FSLIC assessments.

EXHIBIT 6: CAPITAL IN THE SAVINGS INSTITUTION BUSINESS

As of March 31, 1988	RAP Insolvent	RAP Solvent	All
Number	367	2,750	3,117
Total Assets	$137,728	$1,123,145	$1,260,873
Total Liabilities	158,175	1,059,601	1,217,776
Total Deposits	123,087	835,381	958,468
RAP Capital	(20,447)	63,544	43,097
GAAP Capital	(23,028)	54,220	31,192
Tangible GAAP Capital	(26,328)	30,899	4,571

As of March 31, 1988	GAAP Insolvent	GAAP Solvent	All
Number	501	2,616	3,117
Total Assets	$179,766	$1,081,107	$1,260,873
Total Liabilities	199,236	1,018,540	1,217,776
Total Deposits	159,879	798,589	958,468
RAP Capital	(19,470)	62,567	43,097
GAAP Capital	(23,705)	54,897	31,192
Tangible GAAP Capital	(28,000)	32,571	4,571

As of March 31, 1988	Tangible GAAP Insolvent	Tangible GAAP Solvent	All
Number	659	2,458	3,117
Total Assets	$349,059	$911,814	$1,260,873
Total Liabilities	361,266	856,510	1,217,776
Total Deposits	281,207	677,261	958,468
RAP Capital	(12,207)	55,304	43,097
GAAP Capital	(17,716)	48,908	31,192
Tangible GAAP Capital	(33,601)	38,172	4,571

Note: Asset totals are reported on the basis of regulatory accounting principles. Hence, in the identity "liabilities plus net worth equals assets," the figure for "net worth" must be regulatory (RAP) capital.

Still, the issue of who pays for the FSLIC problem is more than just a question of the industry's ability to pay. There is no reason why healthy thrifts, many of whom have vigorously complained about the risky activities of their competitors and the regulatory mistakes of the 1980s, should be forced to pay for the losses created by the failure of their competitors.

Up to this point the entire FSLIC burden has been shouldered by the thrift business. This is an entirely unique situation. Healthy thrifts are put in the position of paying for the mistakes of their competitors whereas other business entities in this country are more likely to benefit when one of their competitors goes under. Thrifts are in the unique position, in fact, of paying to prop up some of their most predatory and ill-managed competitors who continue to drive up the cost of funds and to bid down the yield that can be earned on thrift assets.

The special assessment on the business of over $1 billion per year presents it with an untenable situation. Savings institutions are paying far more than commercial bank competitors for insurance. The rate that savings institutions pay for deposits -- 5/24 of 1% of deposits -- is two and one-half times what a commercial bank would pay, 2/24 or 1/12 of 1%.

And large commercial banks get an even bigger break. For instance, if one aggregates the assets of the two largest banks in the country, Citibank and Chase Manhattan, and if one does the same for the 13 largest savings institutions, the combined total assets for each of the two groups comes to roughly the same -- $237 billion for the two largest banks and $242 billion for the group of savings institutions (Exhibit 7). In 1987, it is estimated that Citibank and Chase paid a combined $59 million for deposit insurance coverage. The 13 largest savings institutions, however, paid almost $330 million. In other words, for the same base of assets, this group of savings institutions paid more than five times as much for insurance as did the commercial banks.

The crowning irony here is that while large banks pay one-fifth the amount that savings institutions pay for insurance, these same large banks are being bailed out by the government from the consequences of their troubled foreign loans, loans for which they themselves bear responsibility for making. In a 1986 paper published by the Brookings Institution, Jeffrey Sachs of Harvard University stated that "[o]perationally, it can be argued that the official creditors are indeed 'bailing out the banks'." (Official creditors are international organizations, such as the World Bank, and various governments or their agencies).

As Professor Sachs points out, in 1983 and 1984, the latest years for which he had data, private creditors (mostly commercial banks) received, from major debtor countries, $11.8 billion more than they lent while official creditors provided net resources of $6.1 billion to those countries. In other words, the official creditor community provided a huge amount of resources to the debtor countries to help them repay their loans to the large commercial banks.

In another paper the following year, Professor Sachs and a Harvard colleague, Harry Huizinga, documents the solicitude with which the U.S. Government treats the big banks:

> "The debt management strategy pursued by the United States and the official financial community since 1982 has been geared toward the protection of the large commercial banks, at least on a short-run accounting basis. U.S. policy has been to maintain current interest servicing by the debtor countries to the U.S. banks and to avoid any explicit debt forgiveness or even capitalization of interest payments."

The inequity is glaring. Healthy savings institutions pay a great deal more in insurance premiums to handle problems they did not create and which they warned against. Still, they get criticised for seeking to minimize that burden. Large commercial banks pay a fraction of what thrifts do in insurance premiums and get bailed out by the government of the problems they themselves created. *It is not reasonable to assume that Congress will allow this extremely unfair situation to continue for another decade or more.*

ACTION #3: IMMEDIATELY STOP CREATING FSLIC DEBT AND GUARANTEES IN EXCESS OF THE AMOUNTS AUTHORIZED BY CONGRESS AND WHOSE COSTS CANNOT BE PAID BY THE FSLIC NOR HEALTHY THRIFTS. (EXPLICIT U.S. TREASURY GUARANTEE OF FSLIC DEBTS WOULD ELIMINATE THIS PROBLEM).

In its July 7 projections, the Board indicated that the FSLIC would have received $2.9 billion in borrowed funds authorized by CEBA by the end of fiscal 1988. On top of that, however, it also indicated its intention to issue FSLIC notes in the amount of $8 billion. Thus, by the end of September 1988, just about a year after CEBA was enacted into law, $10.9 billion in obligations would have been issued by or on behalf of the FSLIC in spite of the fact that CEBA put a $3.75 billion annual cap on that authority. Thus, the Board is clearly circumventing the borrowing limits set by law in CEBA.

And it doesn't stop this year. By the end of September 1989, the Board's numbers show debt outstanding of $15.8 billion (obviously totally beyond the $10.8 overall CEBA limit) and by the end of fiscal 1993, $23.4 billion in obligations outstanding. Unofficially, we have been told that even these recent projections may understate the Board's plans to issue FSLIC notes.

Of course, someone has to pay the interest bill on FSLIC notes and FICO bonds. The Bank Board's own projections show the interest cost on these notes and bonds at $1.20 billion in fiscal 1989 and $1.42 billion in fiscal 1990. Further, we know that the FSLIC has entered into some substantial yield maintenance agreements in recent months. For example, when Southwest Savings received assistance earlier this year, a yield maintenance agreement on *all* problem assets, totaling $2.6 billion, was included. This agreement provided an initial spread of 2.75% over the Texas cost of funds. Assuming the yield to be maintained in fiscal 1989 equals 10% and that most of the assets are non-earning, the total FSLIC *annual* assistance on this one yield maintenance agreement could come to $260 million (a figure that seems reasonable in view of the $2 billion price tag estimated by the FSLIC as the present-value cost of the transaction). *An annual cost of $260 million comes to about one-third of the total regular premium and this is for just one transaction.* Even if only one half this sum is required in this one case, the cost would represent a significant portion of the FSLIC's regular premium income.

During fiscal 1989, the FSLIC's income from its regular premiums will be roughly $865 million. This is $335 million less than the Bank Board's projected interest cost on FSLIC notes and FICO bonds for that same time period. It does not include yield maintenance assistance nor case resolution costs.

The FSLIC special assessments will provide it with roughly $1.3 billion in additional income in fiscal 1989 if there is no phasedown. Thus, the FSLIC's total regular and special premium income for the next fiscal year will come to about $2.16 billion. In other words, at the end of September 1988, the FSLIC's projected debt service ($1.2 billion) will exceed one half of its total income. What remains will be further reduced by yield maintenance and other long-term assistance agreements. This leaves very little for case resolution expenses. It also assumes a continuation of the special FSLIC assessments which cannot be maintained for the long term.

In essence, what the Bank Board's projections show is a highly disguised form of a "Ponzi Scheme". The FSLIC will soon begin using its FICO bond borrowing simply to help it pay the interest on its previously issued FSLIC notes and FICO bonds. Worse yet, the FSLIC is engaging in this charade just so the Board can avoid facing up to the real magnitude of problems facing the FSLIC.

Healthy thrifts see no way they can support this growing FSLIC debt burden. They see the further issuance of notes as a commitment of FSLIC and thrift industry resources that simply do not exist. If the Treasury is willing to guarantee the interest and principal of FSLIC notes, then a continuation of their issuance may make sense. Barring such an explicit U.S. Treasury guarantee, FSLIC should immediately stop adding to its long-term debt whether it is in the form of FSLIC notes, FICO bonds and/or yield maintenance agreements.

ACTION #4 IMMEDIATELY STOP IMPERILING THE FINANCIAL VIABILITY AND CREDIBILITY OF THE 12 FHLBANKS THROUGH BACKDOOR GUARANTEES OR PURCHASES OF EXTRA FSLIC PAPER AND THROUGH LOANS TO THOSE WHO MAY NEVER BE ABLE TO REPAY. (EXPLICIT U.S. TREASURY GUARANTEES OF FSLIC OBLIGATIONS WOULD ELIMINATE THIS PROBLEM).

Under the Competitive Equality Banking Act of 1987, the Federal Home Loan Bank System is required to distribute up to $3 billion of its retained earnings to the Financing Corporation. These funds are to be used to purchase zero-coupon bonds to back the principal of the FICO bonds.

Through May 1988, the System has already provided $257 million to the FICO for this purpose. Its retained earnings have been reduced by a like amount. The commitment to FICO still to be made essentially depletes the remaining $2.5 billion in retained earnings plus another $300 million in future System earnings.

Since the business owns the System, it must be recognized that savings institutions are paying for both the principal and interest on the $10.8 billion of FICO bonds. The reduction in the System's capital is a loss of industry capital and could eventually also increase the cost of consolidated obligations and, by extension, the cost of advances to members. Furthermore, the earmarking of future income to the FICO implies a reduction in future dividends from the System.

While these constitute known costs to the business, even greater concerns have been expressed about another threat both to the System and the business' investment in it. In some parts of the country, the Southwest in particular, failed institutions continue to operate and are paying very high rates for deposits. These high rates not only exacerbate the losses at these failed institutions, but they also crimp the net interest margin of healthy competitors.

Advances from the System are viewed as possible substitutes for these high cost deposits. The assets of the weak institutions are so impaired, however, that they lack sufficient collateral to obtain advances. One suggested solution is for the FSLIC to provide notes to these institutions which in turn can be used as collateral. Alternatively, advances could be made solely with the FSLIC's guarantee.

Furthermore, when an insolvent institution is merged into a healthy one (or, as has been happening in the Southwest, when several insolvent institutions are merged together), the FSLIC routinely provides notes in lieu of cash to help fill up the net worth deficiency. It also provides guarantees of a stated rate of return on certain troubled assets.

In order to liquify these FSLIC notes and the covered assets, the Dallas Federal Home Loan Bank has been making advances collateralized only by the notes or the covered assets. In effect, with the FSLIC short of cash, it has been using the cash of the Dallas Bank to bolster its resources.

In a letter earlier this year to the members of the Dallas Federal Home Loan Bank, the Bank's president wrote that "the board of directors of the Dallas Bank recently authorized the Dallas Bank to fund advances secured by the guarantee of the FSLIC in amounts up to the paid-in capital of the Bank [$1.4 billion as of May 1988] and to accept as collateral FSLIC notes issued in conjunction with Ninth District case resolution efforts."

It is our understanding that the Federal Home Loan Bank of Dallas has now reached the limit set out by the Bank president's letter and that the presidents and boards of directors of other Federal Home Loan Banks are being pressured to step in so that this sort of advance program can be continued.

No one questions the need to reduce the cost of savings at insolvent institutions. The so-called Texas premium is increasing the costs of all financial institutions. The Bank Board has exhibited a willingness to grapple with this very difficult issue and has shown a good deal of creativity along the way. What we are saying, however, is that our investment in the System should not be put at risk by being used to monetize the FSLIC notes to provide liquidity to insolvent institutions. We wonder whether what is being asked of the System should not more properly be asked-of the lender of last resort, the Federal Reserve.

Of all people, we, who work in FSLIC-insured institutions, do not question the FSLIC's guarantee to depositors. Congress has pledged on numerous occasions that it will be honored.

However, we are concerned that the advance program that has been used by the Dallas Bank and is being urged on other banks is but a roundabout way to confiscate even more of our capital to bolster the FSLIC. As mentioned previously, the total retained earnings, and then some, of the Banks has been pledged by CEBA to the FICO. All that is left of the capital of the Bank System is paid-in capital. As the name implies, it is money that our institutions and those of our peers have paid in to the Bank System in exchange for stock, dollar-for-dollar, which we carry as an asset on our books. Any encroachment whatsoever on its value is exactly the same as if the money was taken directly out of our institutions.

Frankly, we are afraid that in a merger of the FSLIC with the FDIC or any other reorganization of the FSLIC, the notes held as collateral by the Banks might be abrogated as a way of taking even more of our capital from us. As we have outlined extensively elsewhere in this paper, we are already paying more than we can afford to rescue the FSLIC and the capital positions are already inadequate at many of our institutions.

At the end of May, our investment in the Federal Home Loan Bank System, the money our institutions paid into it, came to $11.9 billion. That is 38% of the total GAAP capital in the industry and it is intolerable and irresponsible that it is being put at risk.

Any abrogation by the FSLIC of its notes might seem to be of remote likelihood. But we remember last year when the FSLIC secondary reserve was confiscated. Further, to avoid an adverse opinion on the audit statement of the Dallas Bank last year, the FSLIC had to redeem with cash $1 billion in notes that were accepted by the Dallas Bank as collateral. By accepting items of debatable quality as collateral, the System might be exposing itself to risks that it has avoided for the past 50 years. As more of its capital is used as a buffer against assets of doubtful value, the costs of consolidated obligations may increase.

But even more worrisome is the fact that this practice could threaten the value of the System stock held by savings institutions. Since the System's retained earnings are already earmarked for FICO, any further impairment of its capital will represent a direct hit to its paid-in capital. As a result, the accounting community would very likely also require member institutions to recognize a proportional writedown of their investment in the System. This would represent a potentially devastating drain on the precious capital of healthy institutions and at the same time create a large number of additional new thrift insolvencies with the associated huge losses for the FSLIC.

An explicit U.S. Treasury guarantee on the principal and interest of FSLIC notes would remove our concerns. It would allow the Bank System to responsibly lend on such assets as collateral. Barring such an explicit U.S. Treasury guarantee, the Bank System should not accept FSLIC notes or guarantees as collateral for advances.

ACTION #5: REMOVE MANAGERS, BOARDS OF DIRECTORS, STOCKHOLDERS AND SUBORDINATED DEBT HOLDERS OF INSOLVENT THRIFTS IN PREPARATION FOR A MAJOR LIQUIDATION EFFORT IN EARLY 1989

For many years, the healthy segment of the thrift business has urged that the FSLIC deal with insolvent institutions immediately. If resources are not available to liquidate or otherwise resolve the situation, then regulators have been urged to take control of the institution. The Management Consignment Program which allows the FSLIC to in effect create a new thrift, remove management, boards of directors, stockholders and subordinated debt holders is one vehicle that can serve this purpose. This mechanism doesn't require the removal of management or a board of directors if the FSLIC determines they should remain, but it forces such an evaluation and decision.

In some areas, there has been a shortage of replacement management and boards. This has led to the merger of some institutions into MCPs. It has also led to the suggestion that MCP holding companies be formed if necessary. Exhibit 8 shows the number of GAAP insolvent thrifts by state and the number of MCPs created. We believe that the Bank Board has not been aggressive enough in taking these actions and, particularly in canceling the rights of stockholders and subordinated debt holders in some cases. Thus, it insures that the business is rid of high risk and incompetent managers.

It is clear to us that a major liquidation effort will have to begin in early 1989. In preparation for that action, the Bank Board should act to prepare today's insolvent thrifts for immediate resolution next year. Further, it appears that of the 501 GAAP insolvent thrifts as of March 31, 1988, a large number could be resolved for a relatively small resource expenditure. For example, the GAAP equity of the 325 least insolvent thrifts -- 65% of all insolvents by number -- was only -$2.0 billion. The FSLIC could probably have resolved these 325 for less than it spent on case resolutions in fiscal 1988.

Dealing with these problems now will prevent them from becoming bigger problems later on. The FSLIC may have to wait until next year to obtain sufficient resources to deal with today's grossly insolvent thrifts, but there are over 300 institutions that can be handled with the resources available now.

ACTION #6: ENFORCE THE BOARD'S NET WORTH AND GROWTH RULES BY FORCING INSOLVENT INSTITUTIONS TO SHRINK, LOW-NET-WORTH INSTITUTIONS TO SIGNIFICANTLY LIMIT THEIR GROWTH AND BY LIMITING THE NUMBER OF HEALTHY INSTITUTIONS GROWING VERY RAPIDLY

History shows that excessive growth has been a major factor in creating the problem facing the FSLIC today. In turn, much of this too rapid growth results from the failure of thrift regulators to vigorously enforce today's clearly established capital requirements. This is particularly troubling in those instances where low net worth and insolvent institutions have been allowed to grow, and some rapidly.

EXHIBIT 8: THE BANK BOARD HAS NOT BEEN AGGRESSIVE IN TAKING CONTROL OF TODAY'S INSOLVENT THRIFTS . . .

State	Institutions Placed In MCP	MCP In Operation	GAAP Insolvent	MCP As A Percent of GAAP Insolvent Institutions
Alabama	1	1	5	20.0%
Alaska	0	0	2	0.0%
Arizona	1	1	1	100.0%
Arkansas	2	0	14	0.0%
California	27	15	32	46.9%
Colorado	2	0	7	0.0%
Connecticut	0	0	1	0.0%
Florida	6	5	20	25.0%
Georgia	0	0	10	0.0%
Idaho	0	0	1	0.0%
Illinois	6	5	53	9.4%
Indiana	0	0	13	0.0%
Iowa	1	0	8	0.0%
Kansas	2	1	13	7.7%
Kentucky	0	0	2	0.0%
Louisiana	12	5	28	17.9%
Maryland	0	0	6	0.0%
Michigan	1	1	6	16.7%
Minnesota	0	0	8	0.0%
Mississippi	0	0	9	0.0%
Missouri	1	0	10	0.0%
Montana	0	0	1	0.0%
Nebraska	1	1	9	11.1%
New Jersey	0	0	11	0.0%
New Mexico	0	0	6	0.0%
New York	1	0	5	0.0%
North Carolina	0	0	5	0.0%
North Dakota	0	0	2	0.0%
Ohio	1	0	19	0.0%
Oklahoma	5	3	19	15.8%
Oregon	2	1	5	20.0%
Pennsylvania	0	0	5	0.0%
South Carolina	0	0	3	0.0%
South Dakota	0	0	2	0.0%
Tennessee	0	0	8	0.0%
Texas	11	10	132	7.6%
Utah	1	0	3	0.0%
Virginia	1	1	7	14.3%
Washington	1	0	6	0.0%
Wisconsin	0	0	2	0.0%
Wyoming	0	0	2	0.0%
Total	86	50	501	10.0%

Note: There are no GAAP insolvent institutions in Delaware, District of Columbia, Hawaii, Maine, Massachusetts, Nevada, New Hampshire

Efforts to focus regulatory attention on the growth and capital issue have been numerous. As noted earlier, the House Committee on Government Operations recommended in 1984 that, "There should be immediate onsite evaluation of institutions exhibiting excessive growth or significant adverse changes from past performances."

In early 1986, members of the Task Force on FSLIC Issues referred to previously met with Chairman Gray to insist on growth limitations related to capital. In March 1986, this Task Force stated in a report that, "the Task Force believes that MCP and phoenix institutions should be operated in a shrinkage mode."

Healthy thrifts have since continued to stress the necessity of controlling the growth of weak and insolvent institutions. These institutions, if not controlled, have too many incentives to take big risks: if they win their stockholders benefit and if they lose the FSLIC bears the cost.

During its June 21-22, 1988 meeting, the Federal Savings and Loan Advisory Council once again stated its view that growth must be controlled. The members recommended that the Bank Board *freeze* the growth of RAP insolvent institutions as of June 30, 1988. They also suggested that all MCPs should be required to shrink at least 10% a year until they are otherwise resolved.

In our view, all GAAP insolvent thrifts should be forced to shrink. Growth should not be allowed as part of a strategy to preserve questionable assets or in the hope of raising the value of an insolvent institution's subsidiaries. If the cash flow problems of an institution are so bad that growth is required just to pay operating expenses and interest on deposits, then the firm should be immediately merged or liquidated.

Thrifts having positive GAAP equity of less than 3% of liabilities should also face stiff growth limitations. No such weakly capitalized firm should be permitted to grow until it meets its capital requirement. Poorly capitalized firms are clearly the FSLIC's most obvious source of potential losses and should be recognized as high risk operations.

Further, the Bank Board should act to limit excessive growth at any thrift institution. It should be a very rare instance when a thrift grows at an annual rate of 25% or more over a six-month time period. This was recognized by the Bank Board in its own net worth regulations in January 1985 and should be aggressively enforced.

In a letter to a colleague of ours who had complained to the Treasury about the inequity of the government's confiscatory approach to solving the FSLIC's problems, Undersecretary George Gould asked: "Where were you when Ed Gray tried to restrict the growth of those institutions with no capital? I know where your trade group was because I had to deal with them."

As we have documented here, the industry was, in fact, demanding of Mr. Gray, as well as his successor, Chairman Wall, that the Board fulfill its obligation to ensure that insured institutions are operating in a safe and sound manner by reining in those who were growing too rapidly. We can document that we have been pressing the Board on this matter for almost three years. And we might add, in reply to Mr. Gould, that it is an extraordinary role reversal when the regulated industry has to beg its regulator to get tougher.

ACTION #7: LIMIT THE ACTIVITIES OF WEAKLY CAPITALIZED THRIFTS TO RESIDENTIAL MORTGAGE FINANCE AND CAREFULLY MONITOR PRODUCT DESIGN AND PRICING.

One of the major problems with weakly-capitalized institutions is that, with none of the institution's and/or owner's capital at stake, management has every incentive to throw the "long bomb" in an effort to recover its health. If the strategy succeeds, the institution, its management and ownership benefit. If it fails, the insurance agency -- and, by extension, the rest of the business -- is left to pick up the pieces.

In any other business enterprise, the marketplace would put a check on such a strategy. Nobody would lend the necessary funds to a bankrupt or near-bankrupt entity.

With an insured financial institution, however, there is no such check. Lenders (in this case, depositors) look for safety not to the health of the enterprise in which they are investing their funds but rather to the backstop of the federal deposit guarantee. And since the institution is involved in a desperation play, many of the prudential standards that would otherwise guide a management team are often thrown to the wind in the critical two-minute drill.

These are not theoretical, academic concerns. It is an endemic problem. Weak institutions, both banks and savings institutions, are paying top rates to attract funds and are bidding down asset rates (e.g. making ARMs where the initial rate is unrealistically low) to attract borrowers. In the process, they are weakening the whole financial institution system. Mindful of this problem, the Federal Savings and Loan Advisory Council at its meeting on June 21 and 22 of this year recommended that "the loan origination and pricing policies of all supervisory cases should be closely monitored, particularly as it pertains to the issuance of deep discount ARMs."

Since the marketplace does not provide a check on the riskiness of the activities of weak institutions or on their product pricing, it is absolutely incumbent on the regulator to stop the insolvent or weak institutions from throwing the long bomb in this fashion. Insolvent or weakly capitalized savings institutions should be prohibited from engaging in any exotic activities and should, instead, be required to restrict their activities to home finance. The regulator should also carefully monitor their pricing of both deposits and loan rates.

ACTION #8: PROHIBIT WEAKLY CAPITALIZED THRIFTS FROM BIDDING ON AND/OR ACQUIRING WEAK OR INSOLVENT THRIFTS.

Another incarnation of the desperation play on the part of a weak or insolvent institution is to try to portray itself as a "mothership" candidate, take over one or more failed institutions and through FSLIC assistance and forbearances hope to be given the chance to work its way back to health. On the face of it, this may even be an attractive solution, at least in the short run, from the FSLIC's point of view. The weak mothership institution is so desperate that it will take over a failed institution with less cash or other assistance from the FSLIC than a strong acquirer would require. Just the regulatory exceptions alone that are granted in forbearance agreements, executed in connection with such mergers, are of value to the weak acquiring institution.

Again this situation is far from being a hypothetical concern. Almost all of the so-called case resolutions in the Southwest plan to date have been of this variety.

The problem, of course, is that these are not resolutions of problem cases. They are just putting off the day of reckoning. If these were only time-buying devices, that would be bad enough. What is happening now, however, is much worse since there is often a kind of reverse synergy at work in these cases. When you put two problem institutions together, the new problem is often worse than the sum of the two separate ones.

Still, making such acquisitions even more objectionable is the fact that the whole strategy of the weak acquiring institution is that, as part of the deal, it will be granted forbearances. These will allow it to grow rapidly or take other high-risk strategies in a last-ditch attempt to work its way back to health. Usually the odds of it succeeding are slim to none. The bottom line is that, as long as it continues in existence, it will be a disruptive force in the marketplace and when it fails, as it almost ineluctably will, the resulting tab for the FSLIC will be ever so much greater.

ACTION #9: WHEN CAPITAL FORBEARANCES ARE ISSUED, THEY SHOULD PROHIBIT GROWTH AND REQUIRE THAT THE THRIFT LIMIT ITS ACTIVITIES TO RESIDENTIAL MORTGAGE FINANCE.

Some institutions have been granted capital forbearance by the FSLIC on the theory that they are well-managed and can work their way out of their problems. However, the recovery plans filed by some of the recipients of forbearance call for rapid growth as at least one of the steps to work their way back to health.

For instance, Benjamin Franklin Savings Association in Houston has been granted forbearance from minimum capital requirements until September 1994 -- as of March 31, 1988, it had GAAP capital of 0.3% of liabilities. One of its officers told the press that the institution offered regulators a three-tier plan "that includes doubling in size through the purchase of mortgage-backed securities."

Similarly, Columbia Savings of Colorado (GAAP net worth as of March 31 of -$60 million or -2% of liabilities) was granted forbearance on April 13, 1988. In its 1987 10-K filing, the company states that "Columbia's capital restoration plan involves increasing earnings through growth of the association ..."

There is even a memorandum from a Washington law firm to its clients making the rounds noting that Columbia was granted capital forbearance and that its capital restoration plan approved by the FHLBB "was based on, among other things, increased earnings through controlled growth of the institution." The law firm must have an elastic definition of the word controlled. At the end of 1987, Columbia had total assets of $2.8 billion. Its recovery plan called for an off-balance sheet structured asset/liability transaction of $1.5 billion.

In any case, the memo continues with the extraordinary statement (underlined in the original): "The fact that growth was determined to be a permissible part of First Columbia's plan may give institutions some insight into the balance sheet restructuring techniques that the current Bank Board is prepared to condone." Presumably this particular law firm is circulating this information to its client base in the hope that it will be engaged to prepare similar plans for others.

The lack of an appreciation for the fact that rapid growth is most likely a cancer rather than a cure-all is evidenced by a phrase from a study of the savings institution crisis in Texas conducted by the Texas Savings and Loan League:

> "While there was not anything necessarily wrong with this "grow out of it" strategy (which is being utilized even today by the FHLBB, the FSLIC, and various FHLBs in devising strategies to resolve the problems of financially troubled thrifts) ... "

We think that it is outrageous, after all we have been through, that at least some of the thrift regulators still believe in the nostrum of rapid growth as an effective means of restoring an institution to health. We think there is no greater lesson that needs to be learned both by the regulator and the regulated that rapid growth can never be regarded as a way to work out of a serious problem situation. Instead, rapid growth should be regarded as prima facie evidence that an institution is operating in an unsound fashion and, since it is so easily monitored, should be one of the most closely followed danger indicators by the regulators.

ACTION #10: DELEGATE AUTHORITY, WITH APPROPRIATE BANK BOARD GUIDELINES, TO THE DISTRICT FEDERAL HOME LOAN BANKS TO RESOLVE FSLIC CASES WITH UP TO $500 MILLION IN LIABILITIES OR WITH A RESOLUTION COST OF UP TO $50 MILLION.

As we mentioned earlier in this testimony, a great number of the 501 institutions that are reported to be insolvent on a GAAP basis are only marginally so. Thus, the negative GAAP capital of the 325 least insolvent of the 501 came to only $2 billion. Thus, the rolls of the insolvent could be greatly reduced through the expenditure of a relatively small amount of money.

This would have an immediate palliative effect on the public, showing that the number of insolvent thrifts was being greatly reduced. More importantly, resolution of those marginally insolvent cases would keep them from becoming more expensive cases later on.

Something along these lines may be what the Board has in mind with its recently announced so-called "McDeal" program in which it has 21 thrifts for sale, targeted for fast track resolution. They can be acquired with standardized financial assistance packages from the FSLIC. We do not know how successful this approach is going to be -- the closing date for bids is August 5. We congratulate the Board for trying this approach, however, but suggest that expedited handling of cases is needed in a lot more than 21 instances.

We suspect that the reason that there is not more being done in this area may be more a question of personnel resources rather than an absence of cash resources; that the people at the FSLIC are overwhelmed with trying to resolve the large and costly cases. At this point, this is a misdirection of resources. The FSLIC would be better off putting the large cases on ice, while keeping them under strict supervision and on a very short leash and using its scarce means to clean up the many less expensive cases that need resolution.

An even better way to handle these latter cases is to delegate authority to the district Banks to be able to resolve cases up to a certain size -- $500 million in liabilities -- or up to a certain resolution cost -- $50 million. District Banks are closer to these problems and can concentrate their personnel resources to clean up this situation without the time delays involved in a Washington D.C. resolution.

ACTION #11: REQUIRE ALL CAPITAL CONTRIBUTIONS TO BE IN CASH OR CONVERTED TO CASH.

In a number of instances, problems have developed for the FSLIC after a thrift has received a "non-cash" or "in-kind" capital contribution. The Federal Home Loan Bank Board recognized this as a potential problem more than five years ago. In April 1983, the Bank Board proposed new rules regarding the acquisition of non-cash assets. By way of background, the proposed rule states,

> "A significant number of transactions have been proposed or consummated in recent months by insured institutions where certain non-cash assets, primarily land, are acquired either in exchange for securities of an insured institution or contributed to an insured institution. The transactions typically involve an insured institution with severe operating problems and reserves that have declined to levels below that required by the Board's regulations. Although the non-cash acquisitions usually involve significant proposed increases in reserves, the Board believes that certain of these acquisitions are not in the best long-term interests of the acquiring institution or the FSLIC."

The ability to contribute land and other "in-kind" assets as capital together with some appraisal problems has attracted developers and other non-traditional acquirers as thrift investors. In 1983, the Bank Board seemed to recognize that this could lead to non-traditional new owners entering the thrift business with the intention of pursuing a high risk investment strategy. Casual evidence would seem to support the Bank Board's fears.

Unfortunately, neither this proposed new rule nor any variation has ever been adopted by the Bank Board. We question the failure of the Bank Board to adopt its proposed rule of April 1983. In our view, new acquirers should be required to make their capital contributions in cash so that the interests of the FSLIC and the thrift business are protected.

ACTION #12: TIGHTEN THE REGULATIONS SO THAT LOANS TO ANY ONE BORROWER CANNOT EXCEED THE GREATER OF 25% OF GAAP CAPITAL OR $500,000.

One of the tenets of sound banking practice is diversification -- the future of a financial institution should not rest on one loan or even a small number of them. This is based on the eminently sensible idea of not carrying all one's eggs in one basket. That way, if one loan should go bad, it will not bring down the institution.

A way to try to ensure this is to prohibit institutions from loaning more than a certain percentage of their capital on one project or to one borrower. Not only would this help avoid the collapse of the institution if a single loan goes into default, it would also help to prevent self-dealing, insider-dealing or fraud. One way that a financial institution can be looted by insiders is for it to make loans to directors or officers who have no intention of paying the institution back. Regulations that limit the amount that can be loaned to a single individual make it harder to significantly damage the institution through insider dealings.

Currently, a savings institution can invest an amount equal to all of its net worth in one loan. Thus, even a single disastrous loan by a savings institution could be enough to deplete its entire net worth. In contrast, the Congress has, since 1906, imposed a strict limitation upon loans to one borrower by national banks which are prohibited from lending an amount equal to more than 25% of their net worth.

As part of its demand that regulations be tightened to protect the FSLIC, the Task Force on FSLIC Issues, which we referred to earlier and on which we served, recommended in March 1986:

> "altering the loan-to-one borrower regulation to prevent institutions from investing 100% of their capital in a single loan. Specifically, the Task Force recommends that the regulation be changed so that an institution could lend no more than 25% of its net worth to one borrower."

On August 15, 1986, the Board proposed a new regulation limiting loans to one borrower to the greater of 25% of net worth or $500,000 (the $500,000 floor was inserted so that the ability of small institutions to make reasonably-sized loans would not be crippled). Inexplicably the Board has never acted to put this regulation in effect. We strongly urge that the Board resurrect and pass this proposal.

ACTION #13: LIMIT THRIFT INVESTMENTS IN MORTGAGE DERIVATIVES, PARTICULARLY, THOSE MADE BY WEAKLY CAPITALIZED FIRMS

During recent years, thrifts have become increasingly active as mortgage-backed securities investors. They are also major investors in a variety of mortgage derivative securities such as mortgage strips, residuals and zero coupons. The potential significance of these investments is becoming increasingly apparent. At the end of 1987, nearly 300 savings institutions had more than 25% of their assets invested in mortgage-backed securities. Some 30 institutions had MBSs amounting to more than 50% of total assets. Add other investment securities to these holdings and there is obvious reason to question whether such entities are really involved in investment portfolio management or, instead, are in the business of managing a trading portfolio.

Further, it is clear that the business as a whole has recorded significant profits from the sale of investment assets during recent years. Falling interest rates have made this a natural opportunity for our institutions to capitalize on the increased value of their asset holdings. But another way to look at the situation is that some institutions are taking gains on various investment assets while retaining assets which have lost value in portfolio.

Whatever the situation with thrift portfolio management, it is well known in the business that Wall Street has found some thrifts to be aggressive investors in today's more exotic, if speculative, mortgage derivative products. The Federal Financial Institutions Examination Council recently addressed both the issue of trading accounts and the question of mortgage derivative investments in a statement of supervisory policy. In its statement, the Examinations Council notes,

> "The depository institution regulators have become aware of speculative activity which has taken place in a number of depository institutions' investment portfolios. Certain of these institutions have failed because of the speculative activities and other institutions have been weakened significantly as their earnings and capital have been impaired and the liquidity of their securities has been eroded by the depreciation in their market value."

The Council goes on to state when discussing mortgage derivatives,

> "It may be unsuitable for a depository institution to commit significant amounts of funds to long-term stripped mortgage-backed securities, residuals and zero coupon bonds which fluctuate greatly in price."

As we understand it, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Comptroller of the Currency and the National Credit Union Administration all agreed to this policy statement warning about the dangers of mortgage derivative investments. The Bank Board did not follow suit. Instead, it has proposed some new rules concerning the definition of a trading account and some guidance on the selection of securities dealers.

We agree with the Examinations Council that these mortgage derivative investments are very risky. They may not be prudent investments for most thrifts, particularly in large amounts. Some limits on these exotics would probably be in order just to limit the FSLIC's exposure.

More importantly, these high risk but potentially high yielding investments could be very tempting to weak thrifts attempting a "Hail Mary" pass. We believe thrifts not meeting their capital requirements should not be permitted to invest in these mortgage derivative products.

ACTION #14: LIMIT THE USE OF JUNK BONDS, ESPECIALLY BY WEAKLY CAPITALIZED THRIFTS.

Over the last few years, a handful of thrift institutions have become relatively heavily involved in so-called junk bonds--bonds with low credit-quality ratings but high expected yields. There is a threshold question of whether insured deposits should be used to fund junk bonds although the same question could probably be asked about any commercial loan, loans to foreign countries, etc.

For the moment, however, we are most interested in investment in junk bonds from the safety and soundness point of view. Junk bonds have yet to be truly tested in a recessionary environment and we do not think that any institution should be allowed to invest in them if it does not have adequate capital to take sizable losses. Even those that have a lot of capital who adopt a strategy of investing in junk bonds should be monitored very carefully. It might also be appropriate to place limits -- maybe a maximum percentage of assets or, better yet, a limit tied to capital -- on the amount of junk bonds an institution can hold.

ACTION #15: REQUIRE IMPROVED REPORTING AND MONITORING OF INTEREST RATE RISK WITHIN THE THRIFT INDUSTRY.

One of the tendencies of regulators is to fight the last war. For instance, during the crisis in the thrift industry brought on by the extremely high interest rates of the 1981-82 period, thrift regulators were understandably focused on interest rate risk. In retrospect, there clearly was not enough focus on credit risk. However, it was during this period that the seeds for the current FSLIC problems were sown. The current crop of problems are largely credit related and now the regulator is engrossed in dealing with those problems.

Our fear is that some of the business is still susceptible to major problems if interest rates should rise again and that insufficient attention is being paid to this problem. We do not want to understate the strides that most institutions have made getting their balance sheets in better shape as far as matching maturities is concerned. Federal associations were not given the authority to make viable adjustable mortgages until 1981. Even then, the business had to wait until funds became available in 1983 and then it had a major task on its hands to educate the public on the benefits of the ARM.

The press did not help. Financial reporters insisted on portraying the negatives of the ARM without giving any attention to the positives. The Federal Reserve tried to make lenders provide disclosures to borrowers which, again, detailed only the negative aspects of the instrument. Fannie Mae and Freddie Mac, with their emphasis on fixed rate mortgages, made it even more difficult to originate adjustables. Finally, Realtor and builder groups railed against the ARM in spite of the fact that it kept their businesses alive during the tough times of 1983 and 1984.

In spite of all this opposition, the thrift business did a remarkab
of educating the public on the benefits of the ARM. It was helped in
education effort by the wave of refinancings over the last few years.
who had taken fixed rate mortgages during high interest rate periods had
through the time-consuming and expensive (payment of application
appraisal costs, points, etc.) process of refinancing their mortgage in
to get the benefit of lower rates while those who had taken an ARM to
with benefited automatically from lower rates.

But in spite of this outstanding performance by the business gene
some institutions have not done nearly enough. It is still not that
originate profitable and viable ARMs. Some institutions seem to hav
given up trying. For instance, it has been estimated that, as of Septem
of last year, two fifths of our institutions had negative one-year so-
gap positions of 50% or worse. An example of a negative 50% maturi
would be an institution with $100 million in assets where $75 milli
liabilities mature within a year but only $25 million in assets mature
the same period. This means that if interest rates rise, the amou
liabilities increasing in cost will far exceed the amount of assets incr
in yield. This would mean a sharp decrease in profits or actual los
interest rates should rise sharply.

Because of the negative gap of the institutions that have not
themselves into a better maturity-match situation, it has been estimate
a 2% increase in interest rates would cause the interest margin of the
business to drop by 68 basis points, more than wiping out the profits
healthy institutions. We have heard that the Federal Home Loa
presidents are planning to refocus attention on this problem. If so, we
strongly support them and the Bank Board in that effort; if not, we woul
them and the Bank Board to do so.

REFORMING THE DEPOSIT INSURANCE SYSTEM

The focus of our testimony today has been on the problems faci
FSLIC, their magnitude, and the need for a number of Bank Board actions
immediate future. We have not addressed the larger issues of how we
the FSLIC situation early next year nor what the changes are that nee
made in the federal deposit insurance system. We are not prepared
with these issues now nor is the Congress in our view.

We do want to state for the record, however, that we do not fe
today's FSLIC problem results from an inherent flaw in the thrift
What has happened in the 1980s is that the balance between the re
system and the federal deposit insurance system has been thrown
kilter. Because of their original asset-liability mismatch in the earl
and the resulting capital losses, thrifts and the FSLIC have exhibi
worst effects of this imbalance.

We believe the thrift system still plays a vital role in
finance. We feel the system should be preserved for the benefit of
home buyers, and everyone associated with housing finance. When the
addresses the issue of the FSLIC next year, we hope it will look
broader issue of the entire federal deposit insurance system and its
Balance can and must be restored to this system for the benefit
Americans.

GENESIS

THE CREATION OF ASTRONOMICAL LOSSES

Deregulation: Bungled, Unplanned

State Legislatures: Create Free For All

State Regulators: Irresponsible

OMB: Head in the Sand

FHLBB:

- System ill-prepared
- Lack of management competence
- Supervisors and Examiners out of their Depth

Crooks/Highrollers: Rape the System

Trade Associations: Myopic

Depression in Southwest and Co. Compounds Disaster

THE FCA LOSS

A HORROR STORY

HOW REGULATORY MISMANAGEMENT COSTS A BUNDLE

UNCHECKED EXPONENTIAL GROWTH/LOAN PRACTICES -- 1981-

APPROVAL: ACQUISITION OF AMERICAN S&L

AUTHORIZATION OF GIGANTIC INTEREST RATE BET

THE LOSSES GO ON ... AND ON ... AND ON ...

FAILURE TO FACE REALITY IN TERMS OF SIZE OF LOSS.

FAILURE TO TELL CONGRESS WHAT'S REALLY GOING ON.

PERMITTING:

- EXCESSIVE ASSET GROWTH
- UNDERCAPITALIZED COMPANIES TO OPERATE WITHOUT APPROPRIATE CONSTRAINTS
- REACHING FOR YIELD -- E.G.,
  - -- JUNK BONDS
  - -- MORTGAGE DERIVATIVE SECURITIES
- LOW CAPITAL/INSOLVENT COMPANIES TO BID FOR AND ACQUIRE INSOLVENT COMPANIES

INADEQUATE FOCUS ON EXCESSIVE INTEREST RATE RISK

The CHAIRMAN. Thank you, Mr. Shackelford, very much.

That's a roll call vote. We're going to have to go. I hope that some Senators can go over and vote and come back and then go ahead and question when they return.

Secretary Gould, you have argued forcefully against a taxpayer bailout and certainly I think all of us share the sentiment that a taxpayer bailout is something we want to avoid at virtually all cost.

We're not talking about a bailout of course of anybody except depositors. We're not talking about a bailout of management. We're not talking about a bailout of stockholders. We're not talking about a bailout of anyone, as I say, except depositors.

And nobody in Congress prefers to use taxpayer money to clean up the mess, but at some point the problem becomes too big for the savings and loan industry to handle on its own.

Now you're the Treasury's leading expert on our financial system. You've had a vast amount of real world experience in banking and finance. You must have some notion of how we can assess healthy savings and loans before destroying the entire industry.

I want you to tell this committee what that number is and at what point does the problem become too big for the S&L industry? $30 billion, $40 billion, $50 billion? Give us your best judgment.

Mr. GOULD. Well, I've had discussions with my staff in the Treasury with the expectation that someone today might ask me that question, Mr. Chairman.

I honestly believe it is very hard to pin down the number, as I honestly believe it's very hard to pin down the total size of the problem.

But I am perfectly prepared to say there is some level which becomes too great for the industry to bear and, indeed, could be counterproductive for the likes of the institutions these gentlemen run, all of which are superb institutions. If all the industry was like these three people, we wouldn't have a problem.

The CHAIRMAN. But we recognized how serious this problem is. What we did in the legislation we passed last year, we made a hit against the industry that increased the premium from one-twelfth of 1 percent to an additional one-eighth of 1 percent, which in effect as I figure it, for a healthy S&L means that they take a 25-percent cut in their net profit, at least—maybe bigger than that. But at any rate, a very, very strenuous hit that's going to make it hard for them to justify staying in the business.

Mr. GOULD. Well, if the problem were $100 billion, I would say the problem is too great for the industry to handle on its own. And if you start working back down, it's going to apply a greater degree of knowledge than I think I have or that I think anyone else has.

If you recall, Mr. Chairman, last year in our recap plan when we were talking about a full $15 billion of borrowing authority, we had a 5-year phase-down of the special assessment. It was not the Treasury's view that the special assessment should be continued indefinitely. But it is difficult to determine how long the assessment should be continued without doing a set of analyses and I'm not even sure the numbers are readily available. Ths is something, perhaps, the Federal Reserve could do far better than the Treasury.

As to average return on assets of the good part of the industry, when do you begin to make it difficult to attract the capital that you require here? I think you'd have to start with some standard and we simply haven't done that. I am told the S&P 500 is earning approximately 17 percent return on equity at the moment. Do we set that as a common standard? Do we look at the banking system?

It's an area that should require the type of scrutiny that you are suggesting, but I do not know anyone at the moment who's done that precisely. I do want to make the point, that there is a level beyond which the good people in the industry cannot afford to pay without it being counterproductive.

The CHAIRMAN. May I say to you, Mr. Secretary, this is a very, very important question. I do hope that you will reconsider this and perhaps go back and discuss it further. As I understand it, the industry is being hit very, very hard at the present time with the assessment we put on in the legislation we just passed. If we double that or triple it—that's the way to look at it, it seems to me—it would seem to me that you, as our outstanding financial expert, with the kind of experience you've had, should be able to answer this question if anybody in the administration can. I hope—as I said, I'm not going to press you further today, but I hope you will reconsider that and maybe come back to us in writing and give us your estimate in the next few days.

Mr. GOULD. I am flattered by your characterization, Mr. Chairman, but really what you would require here is a grid. There's no one precise answer and then one would have to make a series of value judgments. But it certainly should be explored further and I'd be happy to try to do so.

The CHAIRMAN. Mr. Sandler, would you like to respond?

Mr. SANDLER. Thank you, Mr. Chairman. There are two comments. No. 1, I'd like—it's kind of interesting, Mr. Gould said certainly $100 billion is too much. In March 1986, I attended a meeting in the board room of the Federal Home Loan Bank Board with then Chairman Gray, Mr. Gould, some of his staff, and a bunch of other people, and at that time Secretary Gould was showing us what the new recap bill was likely to be. This was in the beginning stages. And I was challenging Mr. Gould, since I opposed it very vigorously, and I asked him this question. I said, "Mr. Gould, if the losses are only $2 billion there would be no issue here, isn't that correct?" And Mr. Gould said, "Of course." And we both agreed on that.

And I said, "The only reason you're really here with the industry today is because you and Chairman Gray then believe the problem was a $6 to $12 billion problem," which is what Chairman Gray was saying at that time. And Mr. Gould acknowledged that's pretty much it. He said, "You're better than the taxpayer." And I said, "And what, sir, if it turns out to be a $25 to $40 billion problem?" And Mr. Gould at that time said, "Well, obviously, that's a horse of a different color and we'll have to face that when that time comes."

Well, the time is now, except now the numbers move from $25 to $40 billion to $100 billion.

Second——

The CHAIRMAN. Mr. Sandler, this is a very, very good answer and a very important answer. For 22 years I haven't missed a vote on the floor of the Senate and I don't want to miss one right now, so I'm going to have to interrupt you so I don't break my 22-year record. As soon as I come back you can finish up.

Mr. GOULD. Do I get a rebuttal then, Mr. Chairman?

The CHAIRMAN. Of course you do. We're going to have to recess the committee for the next few minutes.

[Recess.]

The CHAIRMAN. The committee will come to order.

Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Secretary Gould, you mentioned that you have a chronology of congressional inaction on FSLIC. I wonder if you could submit that chronology for the record.

Mr. GOULD. Yes, sir. I would be very happy to do so.

[The following was subsequently submitted for the record:]

FHLBB ESTIMATES OF FSLIC LOSS

("ALICE IN WONDERLAND")

DATE	WITNESS	PROJECTED LOSS*
MAY 1986	GRAY	$16.0 BILLION
JAN. 1987	GRAY	$23.5 BILLION
FEB. 1988	WALL	$15.0 BILLION
MAY 26, 1988	WALL	$22.7 BILLION
JULY 7, 1988	WALL	$42.5 BILLION (?) $30.9 BILLION (#)

*(BASED ON FSLIC CASELOAD)

CHRONOLOGY OF THE FSLIC RECAPITALIZATION

1. 5-10-84 An FHLBB issue paper states concern over the dwindling FSLIC insurance fund and considers recapitalizing the FSLIC with higher premiums or requiring thrifts to maintain deposits at the FSLIC.

2. 2-20-85 FHLBB Chairman Gray proposes the one percent solution to the House Appropriations Subcommittee on HUD.

3. 10-18-85 Rep. Parris asks the GAO to report on the condition of the FSLIC.

4. 2-12-86 The GAO estimates the FSLIC may need as much as a $22.5 billion recapitalization.

5. 2-27-86 The Administration's Economic Policy Council approves a recapitalization plan for $15-$20 billion of new funding for the FSLIC to cover up to $30 billion of case resolution costs over three to five years (the full Administration plan).

6. 3-4-86 Under Secretary of the Treasury George D. Gould testifies before the Senate Banking Committee in support of the Administration's FSLIC recapitalization plan and its three pronged strategy to revitalize thrifts.

7. 3-12-86 Under Secretary Gould testifies before the House Banking Subcommittee on Financial Institutions in support of the Administration plan.

8. 3-12-86 The U.S. League's board of directors adopts an FSLIC recapitalization plan with less funding.

9. 3-13-86 Chairman Gray testifies before the Senate Banking Committee that the FSLIC will need $16 to $23 billion to resolve cases over five years.

10. 3-20-86 Under Secretary Gould testifies before the House Banking Subcommittee on Financial Institutions on the problems within the thrift industry and the need to enhance the FSLIC's resources.

11. 5-6-86 The U.S. League testifies before the House Banking Subcommittee on Financial Institutions that only $8-$15 billion is necessary to resolve cases.

12. 5-8-86 Under Secretary Gould testifies before the House Banking Subcommittee on Financial Institutions in

support of the full Administration plan and its three-pronged strategy to revitalize FSLIC and thrifts.

13. 5-21-86 S. 2491, the Administration FSLIC recapitalization plan, is introduced by Senators Proxmire and Garn.

14. 5-22-86 H.R. 4907, the Administration plan, is introduced by Reps. St Germain and Wylie.

15. 6-6-86 Under Secretary Gould writes Chairman St Germain, urging the Committee to avoid amendments that would restrict the use of FSLIC resources to resolve insolvent thrift cases.

16. 6-11-86 Chairman St Germain cancels Subcommittee mark up of H.R. 4907.

17. 6-12-86 Chairman St Germain cancels Subcommittee mark up of H.R. 4907.

18. 6-19-86 Chairman St Germain cancels Subcommittee mark up of H.R. 4907.

19. 6-24-86 Chairman St Germain cancels Subcommittee mark up of H.R. 4907.

20. 6-24-86 Senator Garn introduces S. 2582, a comprehensive banking bill that includes the full Administration plan.

21. 7-17-86 The House Banking Subcommittee on Financial Institutions reports H.R. 4907, the full Administration plan.

22. 7-21-86 A GAO letter to Chairman St Germain warns that the problem could be larger.

23. 7-28-86 The U.S. League urges a "pay-as-you-go" plan in a letter to the House Banking Committee.

24. 7-30-86 A letter to Chairman St Germain from 16 Committee members, including Rep. Wylie, requests a full Committee mark up of H.R. 4907.

25. 7-31-86 Chairman St Germain responds in a letter to Rep. Wylie with concerns over nonbank banks.

26. 8-1-86 Rep. Wylie again writes to Chairman St Germain requesting a full Committee mark up of H.R. 4907.

27. 8-13-86 Senator Garn drops all of the banking provisions from S. 2594, other than the full Administration plan and two other emergency provisions.

28. 8-13-86 The Senate Banking Committee reports a stripped-down banking bill (including the full Administration plan concerning the FSLIC) and assigns a new number to it, S. 2752.

29. 8-13-86 Senator Proxmire says he will use all means at his disposal to prevent consideration of S. 2752, the FSLIC recapitalization bill, on the Senate floor, unless a controversial amendment to impose a moratorium on nonbank banks is adopted.

30. 9-12-86 Senator Proxmire files amendments to S. 2752 on the Senate floor, including a nonbank bank moratorium, and states that it would be better to have no FSLIC bill than one that does not include the moratorium amendment. He also reserves his right to speak at length against a FSLIC bill.

31. 9-19-86 Chairman St Germain introduces a new bill, H.R. 5565, which includes not only the Administration's FSLIC plan, but also a housing and other extraneous titles.

32. 9-23-86 Chairman St Germain introduces another new omnibus bill, H.R. 5576, which includes the Administration plan, the housing title, and other extraneous titles.

33. 9-23-86 The House Banking Committee reports the new bill, H.R. 5576, with the recapitalization plan and other extraneous titles, after dropping the provisions on nonbank banks.

34. 9-29-86 H.R. 5576, as passed by the Banking Committee, is pulled from the suspension calendar.

35. 9-29-86 Senator Proxmire files on the Senate floor additional, extraneous amendments to S. 2752.

36. 10-1-86 Speaker Wright blocks House consideration of H.R. 5576 because of concerns over Texas thrifts, according to the Wall Street Journal.

37. 10-7-86 Chairmen Gray, Volcker, and Seidman urge Congress to pass a clean FSLIC recapitalization bill.

38. 10-7-86 The House passes H.R. 5576 by voice vote under suspension of the rules.

39. 10-16-86 The U.S. League urges Congress to pass the full Administration plan before adjournment.

40. 10-16-86 Chairman St Germain urges House Appropriations Committee Chairman Whitten in a letter to oppose a possible Senate attempt to attach the FSLIC recapitalization bill (S. 2752) to the continuing resolution.

41. 10-16-86 Floor time for S. 2752 is denied because of the controversial nonbank bank title, according to an article in the *American Banker*.

42. 10-16-86 Senator Proxmire states that the FSLIC can wait, because the nonbank issue is more important, according to an article in the *American Banker*.

43. 10-17-86 Senator Proxmire agrees to withdraw the nonbank bank amendment, but a new provision restricting thrift direct investment is added to the FSLIC bill; Senator Garn agrees.

44. 10-18-86 A new bill, S. 2443, which contains the full Administration plan plus other emergency provisions, passes the Senate hours before adjournment Sine Die. (The direct investment provision was dropped after objections by other Senators.) The House does not consider it, however, even though it was the very last matter discussed before the end of the 99th Congress.

45. 10-18-86 Chairman St Germain issues a statement accusing the Senate of killing the recapitalization bill by making substantial changes in the consumer, housing, and regulatory titles during the final hours of the Congressional session.

46. 1-6-87 H.R. 27, the full Administration plan, is introduced by Reps. St Germain and Wylie (with $15 billion in new funding).

47. 1-6-87 S. 45, the full Administration plan, is introduced by Senators Proxmire and Garn (with $15 billion in new funding).

48. 1-21-87 Under Secretary Gould testifies before the Senate Banking Committee in support of a clean FSLIC bill.

49. 1-22-87 Under Secretary Gould testifies before the House Banking Committee in support of a clean FSLIC bill.

50. 2-3-87 Chairman St Germain cancels the February 3 Subcommittee mark up of H.R. 27.

51. 2-9-87 Speaker Wright endorses a plan providing only $10 billion in new funding for the FSLIC with forbearance provisions to assist troubled thrifts.

52. 2-10-87 Chairman St Germain cancels mark up of H.R. 27.

53. 3-2-87 Treasury Secretary James A. Baker III writes to Senator Proxmire urging that the full Administration plan be put into a clean bill.

54. 3-3-87 The GAO testifies before the House Banking Subcommittee on Financial Institutions that the full Administration plan represents the minimum necessary and that the FSLIC is insolvent.

55. 3-6-87 In a letter to the GAO, the U.S. League accuses Treasury of trying to "frighten" Congress into passing a "bloated" plan.

56. 3-9-87 FHLBB Chairman Gray writes Senator Garn that the FSLIC is more insolvent than the GAO reported.

57. 3-10-87 Secretary Baker addresses the National Council of Savings Institutions on the need for the full Administration plan.

58. 3-10-87 In a letter to Chairman St Germain, the GAO defends its position against the U.S. League's attack.

59. 3-10-87 A plan providing only $7.5 billion in new funding for the FSLIC (S. 45) is reported out of the Senate Banking Committee together with numerous, extraneous provisions.

60. 3-10-87 Chairman St Germain cancels the Subcommittee mark up of H.R. 27.

61. 3-18-87 The GAO defends its position in a letter to the U.S. League.

62. 3-23-87 Secretary Baker writes to the members of the Senate urging support for the full Administration plan.

63. 3-25-87 Secretary Baker writes to Senator Garn urging passage of the full Administration plan.

64. 3-25-87 Under Secretary Gould writes to the members of the Senate urging passage of the full Administration plan.

65. 3-27-87 The Senate passes S. 790, which contains a plan providing only $7.5 billion in new FSLIC funding and other extraneous and controversial amendments in the Competitive Equality Banking Act.

66. 3-31-87 The House Banking Subcommittee on Financial Institutions reports the full Administration plan, 42-1.

67. 4-1-87 The House Banking Committee reverses the subcommittee vote and reports a plan providing only $5 billion in new FSLIC funding, 45-5.

68. 4-20-87 Secretary Baker writes Senator Garn opposing the $5 billion plan and calls for the quick passage of the full Administration plan.

69. 4-28-87 The FHLBank presidents write to Chairman St Germain and express their opposition to the $5 billion plan.

70. 4-28-87 Reps. Wright and St Germain issue a joint statement calling for a compromise plan that includes the full $15 billion in new funding and forbearance.

71. 5-4-87 Secretary Baker writes Reps. St Germain and Wylie supporting the full Administration plan.

72. 5-4-87 The GAO states that the FSLIC is $6 billion in deficit.

73. 5-5-87 H.R. 27 passes the House after the St Germain amendment to increase the FSLIC plan to $15 billion in new funding from $5 billion was defeated, 258 nays to 153 yeas.

74. 6-1-87 The Administration issues a policy statement urging adoption of the full Administration plan.

75. 6-9-87 Chairman St Germain excuses FHLBB General Counsel Bill Black from testifying and cancels the subcommittee hearing on problems in the thrift industry.

76. 6-11-87 House appoints conferees.

77. 6-22-87 Secretary Baker urges the conferees in a letter to pass a responsibly funded recapitalization bill.

78. 6-23-87 Conferees meet, but come to no resolution.

79. 7-1-87 Conferees approve a plan providing for only $8.5 billion in new funding.

80. 7-29-87 Secretary Baker's continuing negotiations with the conferees increase the package to $10.8 billion in new funding to cover over $20 billion of case resolution costs.

81. 8-3-87 The House passes the $10.8 billion plan.

82. 8-4-87 The Senate passes the $10.8 billion plan.

83. 8-10-87 President Reagan signs the $10.8 billion plan into law (Pubic Law 100-86).

Senator GARN. And, Mr. Gould, what other experiences has the Treasury Department had recently with industry groups seeking taxpayer assistance to alleviate financial difficulties and what has been the outcome of these experiences?

TAXPAYER ASSISTANCE

Mr. GOULD. During the little over 3 years now that I've been here, we've had a lot of people come through my office, almost all of whom want money. But I suppose if I were to find two analogies here, I think the most obvious is the Farm Credit System and another would be our experience with the steel industry in the last few years.

Let's take Farm Credit. When I first came to the Treasury in the fall of 1985, the Farm Credit System came in and said they needed $10 billion to bail out the system or there wouldn't be enough credit for spring planting. Fortunately, I believe, we resisted that. We got a piece of legislation which used about $4.5 billion of their earned surplus first, before any consideration of taxpayer funds, and then got a second piece of legislation which allowed some Treasury guarantees that will be repaid.

The net of all that, Senator, is that after coming and asking for $10 billion at the front end, the Farm Credit System will ultimately cost the taxpayer not $10 billion, but more like $1.5 to $2 billion and the chances are very high that will be repaid.

In the meantime, as you would well know, sir, the industry has recovered right before the drought and we had a chance for a cyclicality to work in our favor. Things got better and therefore the losses weren't as great. The point is, it was necessary to resist the $10 billion.

Very quickly, a similar circumstance occurred a couple years ago in the steel industry when they came in and—if I remember the number correctly, don't hold me to it exactly—asked for a $6 billion bailout. They were operating I think around 70 percent of capacity perhaps at that time and were concerned about their pension funds. We continued to talk, but in fact the steel industry is now operating at over 90 percent of capacity. Certain products are on back order and they don't need anything.

So you have to be a little careful about the first request for the money. It needs analysis. We need to see whether there's a cyclicality that could work in our favor. Things can get better. Things don't only get worse. I'm sure there are a number of other examples, but those are two that come immediately to mind. We resisted it and it corrected itself.

Senator GARN. Gentlemen, you three representing the S&L industry, or maybe just yourselves after listening to your testimony today. I want to be very clear. I am just about as passionate as Mr. Sandler on this issue and you particularly, Mr. Levy—we've known each other a long time and I have high respect for you. I don't like double standards. I don't disagree with a lot of what you've said. There's enough blame to go around and there has been no Senator that has been more critical not only in this area but in a number of areas of Congress, and I certainly have never been afraid to vent my criticism of regulatory agencies.

I don't disagree with a lot of what you've said. That isn't the point. But it really bothers me when I've been in the middle of this for 10 years in virtually every meeting of any substance for 10 years and then to suddenly hear, other than a brief reference to the trade associations, that it's all a problem here. It isn't. There's a lot of problem all the way around.

So it's fine to talk about bungles and unplanned actions and so on, but I've been involved in all those meetings with the industry. I've been here when the chairman has been criticized for trying to increase capital. Who opposed increased capital for years? The industry. Isn't that right, Mr. Chairman?

The CHAIRMAN. Right.

Senator GARN. Every single time we talked about it, it was, "Oh, yes, we agree, but make it effective in 1995 or 1990. It isn't a matter of how much. We're willing. We agree to increase capital, but make it effective after I'm no longer CEO." Virtually everything some of us have talked about in this committee has been opposed by the industry for a number of years.

Mr. Levy, in your prepared statement, you're quite critical of the enforcement record of the Bank Board. You also note that you organized a task force to study FSLIC's problems in 1985, which included a study of the Bank Board's enforcement efforts. In testimony given in September 1985 before this committee you stated—again, I assume this is the U.S. League's position:

> Our general sense is that the Bank Board, especially in recent years, has exercised its prosecutorial discretion in an intelligent manner, choosing remedies that are appropriate to institutions' conduct.

In 1986, you testified before the House Banking Committee,

> While the U.S. League acknowledges there is a need for bolstering FSLIC and its supervisory tools, we believe that immediate attention to the condition of the insurance fund in our industry has been out of proportion to the magnitude of any realistic assessment of our problems. Certainly inadequate attention has been paid in the press to the remarkable overall improvement in the operational conditions of the vast majority of our member institutions.

In 1984 and 1985 you testified,

> The U.S. League has been supportive of all these steps and is confident they are already producing results for FSLIC. The U.S. League must caution that our support for tougher supervision does not automatically mean that we endorse still further regulation.

And then, as you note now, the opinion of that task force is that the Bank Board did not have the supervisory situation under control.

Well, there's a big difference between your testimony today as an individual and your testimony as a representative of the U.S. League—which presented a very rosy picture—and that was at the very time I was pushing $15 billion of FSLIC recap and the U.S. League was vehemently opposed to $15 billion of FSLIC recap.

So I'm puzzled. Is your testimony today that of Mr. Levy, individual, and the truth is that you disagreed with that testimony in 1984 and 1985 and 1986 about this rosy picture—that the Federal Home Loan Bank Board was all right and FSLIC was taking proper steps. I can remember that you were here as an officer of the National League of Cities presenting testimony supporting that picture that as mayor of Salt Lake City I did not agree with. Now where is it that you stand?

Mr. LEVY. Well, let me start by saying that we point out shared blame. I think up to this point there's been a sense that all of the blame falls on the industry, the industry is responsible for the loss. We share a major part of it. There isn't any question. There are institutions that hated putting on added capital. The first meeting I ever attended nationally of the savings and loans dealt with capital questions in 1977 about reducing the capital standard from 5 percent to 4 percent. At that meeting I said it was like raising the average temperature of the normal person from 98.6° to 101° and now he's healthy. I mean, I've been in favor of capital standards from the start and I would agree that many, many people in the industry opposed it. They had no concern about it.

So the question of where we stood—remember that we were operating throughout that period with the information at hand. We operated on the theory that the regulators, the supervisory people were doing their job. I point out that not 90 days ago the Chairman of the FDIC in all good faith believed that the size of the problem at First Republic would not exceed $1.7 billion. We discover today it's $4 billion. Now he wasn't misleading us. It was based on the information he had at hand on that date.

In 1985, we thought the problem was under control. How could we know that through the MCP program an institution in Dallas, TX could be operated under total supervision of the Dallas bank and discover in March of this year that there was a $1.2 billion embedded loss that had never been recognized. We don't have that information at hand. Or how was it that in December 1985 when we sat down with that task force that we asked for information on growth of institutions, we had a growth rate that had gone into effect in January 1985 that required every institution that was to grow over 25 percent to receive special permission from the Bank Board, and to discover in 1985 in December that sizable numbers of insolvent institutions in Texas were growing at over 25 percent. That astounded us and we called for meetings with Chairman Gray and we protested and asked that they stop this growth thing from going on.

Having said all that, there are times I'm sure, as you spoke for cities on positions you didn't agree with, that much that goes on in trade groups is dealing with consensus. Of course, you were receiving notes in your meetings on forbearance because the people most directly affected—the failing institutions—saw this as their great salvation. We saw it as prolonging the agony, but we couldn't overcome that. Self-interest was so strong on the part of those institutions and they represent a sizable number of institutions—either those directly insolvent or those knowing their own balance sheets realizing that they were heading for insolvency and those people were the most outspoken and vociferous in their support of forbearance.

Senator GARN. Well, my time is up, but believe me, no one came in from the U.S. League and spoke against forbearance provisions. Chairman Proxmire and I were opposed to them. But again, the thing I'm trying to point out—I want to repeat what the U.S. League's testimony was before this committee in 1986 at the time that a majority of this committee was trying to pass a $15 billion FSLIC recap. The administration, George Gould, was calling me about every other day getting me to back off my big bill, which I finally did and went with a clean FSLIC recap, and this was the U.S. League's testimony.

I quote:

> While the U.S. League acknowledges there is a need for bolstering the FSLIC and the supervisory tools, we believe immediate attention to the condition of the insurance fund in our industry has been out of proportion to the magnitude of any realistic assessment of our problems. Certainly inadequate attention has been paid in the press to the remarkable overall improvement in the operating conditions of the vast majority of our member institutions.

That was 1986. This Senator was here saying that was bull and that there was a huge problem, trying to get some FSLIC recap passed, while at the same time the industry was opposing it.

So again, I'm just trying to get some balance. I don't disagree with you. Regulatory mistakes have been made and mistakes have been made by this Congress—boy, I'll testify to that, but I can't sit here and look at charts that dump it all on this side of the coin in light of that kind of testimony in 1986. We didn't have an exact number on it any more than we do today. I don't know what the number is. It's a terrible problem. But the point of it is, this is the testimony we were getting from the League 2 years ago and anybody that had their eyes open knew that there was a big problem.

My time is far gone. I've got to quit or the chairman is going to bang me with that gavel.

Mr. **Levy**. May I respond?

The **Chairman**. Senator Riegle is next and he says go ahead.

Mr. **Levy**. Just in response, I agree with you totally, but there were things going on that we had no knowledge of. For example, Western Savings in Dallas had gone 3 years without a Federal exam and we suddenly discover late in 1986 that there was over a billion dollar loss in an institution we weren't even aware of. We were constantly finding out new things and I agree there were statements made—we thought things were improving in 1986, institutions were starting to earn money. Little did we know the size of the embedded loss or that 2 years later the economy of Texas would still be so depressed that real estate values would be so low that we would be looking at this massive loss.

And again, I restate, if there's some sense that we're laying this problem at the foot of Congress, I dispel that. There are major players involved in this. The regulators were involved. Congress was involved. The administration through OMB was involved. And most prominently, the industry was involved and the trade groups were involved, individual savings and loan managers were involved. There's more than enough blame to go around. Mistakes were made by all, including me, including all of the people I know in the business. I listened to positions taken during those periods, fought against them, some supported. They were wrong.

Senator **Garn**. That testimony that I read was after the task force had completed their business, and it said that the opinion of the task force was that the Bank Board did not have the supervisory situation in control and that it was shocked and outraged that so little was being done to keep the problems from getting bigger.

That task force report that I just quoted was prior to the testimony of the U.S. League saying everything was rosy.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

I think we're getting very valuable insight and testimony today, and I appreciate the candor. I must say that I agree with the statement that has just been made that assigning responsibility for what is truly a disaster is difficult. There is very widely shared responsibility, and getting the sequence straight as to what happened is very important.

Having said that, there are people that are directly responsible and who are paid to prevent this kind of a problem from happening, and those are the regulators. We have a regulatory system precisely to prevent this kind of a problem from happening, and if the regulatory system breaks down or if there are not enough people, if they don't know what they're doing, if they're not conducting audits such as the one that you talked about, then it seems to me that you're going to have an inherent set of problems spiraling ever more out of control. I think even today we're not certain as to precisely where we stand. I view that as a central part of the problem, without relieving anybody else—the administration, the Congress or anybody else—of their responsibility for this.

Let me ask the three witnesses here if you've got any reactions or responses to what Mr. Gould has said.

Mr. SANDLER. I was wondering, Mr. Chairman, if I could pick up on where we were when you went to cast your vote.

The CHAIRMAN. Go ahead.

Mr. SANDLER. Just by way of background, it's interesting to note—I checked to find out what the FSLIC losses were between 1934 when it was initiated and 1981. You might be interested to know that during that period of regulation, if you will, the losses were approximately $630 million. It's fascinating what's happened just in the 7 years as compared to the first 47 years. Something about the deregulatory process and the way it operated has created these losses.

I also want to point out that the trade association, as I noted, was guilty, but there are a lot of us, Senator Garn, who are simply residential lenders and haven't used any of the deregulatory tools, have high net worth, low nonperforming assets and we're trying to figure out how did we get caught up in all this? We wanted higher capital and we lost in the trade group and apparently the regulator lost to the trade group. I don't understand why if the trade group argues for lower capital and the regulator knows higher capital is necessary why the regulator doesn't have the guts to move forward on it.

So if there is blame, let's analyze how much of the blame belongs to the industry.

THE AFFORDABILITY QUESTION

I want to get to the question you asked Mr. Gould, Mr. Chairman, and I was kind of surprised he didn't have an answer because it seems to me that what you're getting at is the affordability question. The equity question, I think, for companies like ourselves is fairly clear. The affordability question. Let's take a hypothetical. If we raised the assessment to one-half of 1 percent, obviously of the 2,500 solvent institutions a large percentage of them, most of them, would go under within 1, 2 or 3 years. They could not live with that because that would be equal to their earnings and they would start to go down. So that's a clearcut case.

So the point Mr. Gould is making I guess is that one-eighth of 1 percent is OK. But the point is it's not so hard to analyze what the impact of one-eighth of 1 percent will be. We know, for example, that last year *x* number of institutions were unprofitable that would have been profitable if they didn't pay that one-eighth of 1 percent and we know that you can slice the industry into its segments and those numbers are all available to the Federal Home Loan Bank Board and it really doesn't take a statistical genius to work those numbers out and to determine what the impact will be and it's obvious that as more and more companies become weakened, then they will go into a loss position and they will create losses which will then be larger than the additional assessment.

So those things are capable of analysis and I frankly would have thought the Federal Home Loan Bank Board would have had an analysis of what the impact of that one-eighth of 1 percent assessment is.

And we haven't touched, incidentally, on the competitive assessment. Why is our company, a company with net worth approaching 6 percent on a GAAP basis, why are we paying one-eighth more than a bank which has a capital ratio of 2 percent? I have one of the lowest nonperforming asset ratios of all majors in the industry, far lower than most banks. Why does a bank with 2 percent capital and large number of nonperforming assets pay significantly less and I'm trying to compete with it for the same deposits and borrowers? The incentive is insane.

Then, the most important point is, no matter what the losses are, if they're $40 billion, $50 billion, $60 billion, the point is that even by the Federal Home Loan Bank Board's own analysis, the current operating losses without regard to writedowns or any other problems are at least $6 billion and growing. That means that if you don't massively infuse and liquidate these institutions, the problems are going to get worse. So what we're doing is we're being dilatory and putting it off until tomorrow. But between today and tomorrow, we're going to incur another $3 to $6 to $10 billion in costs. So the point is, you must deal with it now. If you feel that—if you in your infinite wisdom—you and the next administration—believe that we should pay a portion of it, then assess us then. But we're begging you, solve the problem today before it gets larger. The idea—we know this is a budget buster. I know if Senator Gramm was here he'd go berserk over what we're talking about.

The CHAIRMAN. You're talking about the Republican Gramm?

Mr. SANDLER. Yes. This is a budget buster. But if you know that if it's $60 billion today and it's going to be $75 billion a year from now and $100 or $110 billion 3 years from now, if you continue to go along, if you will, piddling—which is what we're doing—it's not good public policy and the Congress in two sessions from now will be dealing with a much larger problem. Why not solve it now, put it away. If you think we have to pay something, tell us what it is and we'll pay it. But you're going about it the wrong way.

Senator RIEGLE. My time is up, Mr. Chairman.

Mr. GOULD. Mr. Chairman, could I respond to that or how do you wish to proceed?

The CHAIRMAN. Well, the next Senator to be recognized is Senator Heinz. Senator Heinz, would you permit Mr. Gould to respond on the committee's time, not on your time?

Senator HEINZ. By all means.

Mr. GOULD. Thank you, Senator.

Let's be careful about vocabulary. Let's not make public policy on a quick statement that says since we know the problem is $60 billion now and will be $75 billion next year we've got to do something. We do not know that.

Now let me try to establish a couple of facts. This may be quite of interest to you, Mr. Chairman. Treasury Secretary Jim Baker, as Chairman of the President's cabinet council for dealing with economic matters, the so-called EPC, got approval on February 27, 1986 for me to appear before the Congress with a plan which would create through borrowing and regular assessments and a 5-year phased-down special assessment up to $30 billion of case resolutions over 3 to 5 years—the so-called administration plan.

Now if there's been a lot of delay, it sure hasn't been on the part of the Secretary of the Treasury. That was authorized. That came forward. I testified before this committee shortly thereafter on the 4th of March, 1986, with that plan.

Now where did we come up with the numbers? We came up with numbers from the General Accounting Office on whom we have depended throughout this period for our advice. We have no ability to go out and analyze every loan and every portfolio of the S&L industry. I will tell you that nobody knows what that number is unless they have that ability and unless they factor in other variables such as interest rates.

Senator RIEGLE. Mr. Chairman, if I may. Mr. Gould, there are people in the Government today in very responsible positions—I'm not going to name them, but I could and you know who I'm talking about—who in fact have gone in and have done an appraisal of what the losses are in the savings and loan system. The losses are in the magnitude that's being talked about here today. Now, Mr. Gould, if you don't know that, then I think it's one thing to make the assertion that the losses are far less. If you do know that, then I think it's a material misrepresentation.

Mr. GOULD. Well, sir, there's no material misrepresentation. If you're referring to the FDIC, the FDIC has looked at this. The Fed has looked at this. We must be very careful, Mr. Riegle, about the assumptions we use.

I have in my hand a May 19, 1988 report of the General Accounting Office. Am I to say to Mr. Wolfe whose report and testimony this is that he doesn't know what he's talking about? I will tell you, sir, what you really have to go through to really pin this number down is a lot more work than anyone has done. There's a little contest going on now, which includes some consultants. To get the most publicity you've got to have the biggest number in town, and I don't buy that. I am perfectly happy to look at any valid analysis, but I also wish to look at the assumptions and see whether I agree, not merely with the conclusatory number, but indeed with the assumptions that go into it and the variables.

I am not aware of anybody who I respect—I'll use that as my premise—that has told me there's $100 billion of problem out there.

Senator HEINZ. As I was saying——[Laughter.]

The CHAIRMAN. Senator Heinz.

Mr. GOULD. But I would also like to say, just for the record on this——

The CHAIRMAN. Would you get Senator Heinz' permission? Senator Heinz, is it all right for Secretary Gould to continue?

Senator HEINZ. As long as it doesn't occasion a prolonged discussion.

The CHAIRMAN. Secretary Gould, we'll give you 30 seconds.

Mr. GOULD. This is part of my chronology for the record. I'd suggest it's worth reading.

On May 6, 1986, the U.S. League testifies before the House Banking Subcommittee that only $8 to $15 billion—this isn't borrowing—is the total cost necessary to resolve cases. Now the difference of opinion has been clear. We came forward with $30 billion in case resolution and that's still not a bad number to have available. So it's worth looking at what the history really is here.

The CHAIRMAN. Thank you. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

Mr. Gould, what's the administration's position on what we ought to do about the problem? Should Congress sit tight or do you advocate, for example, that the Bank Board and the FSLIC move much more aggressively on the troubled thrifts?

Mr. GOULD. A very valid question, Senator.

Senator HEINZ. Which do you advocate?

Mr. GOULD. Let me try and see if I can answer it as accurately as possible.

Senator HEINZ. Please, answer it briefly because I have a lot of questions for these other witnesses.

ADMINISTRATION'S POSITION

Mr. GOULD. The administration's position is that there are funds available to the Bank Board created not by passing a full recap but by what was passed that gives them $19 billion over the next 3 years. They claim and I tend to agree that's as much money as they can spend effectively during that time. They're on a path of the resolution of two cases a week. Now just organizationally that's a lot of work.

Senator HEINZ. What about keeping the sick thrifts from going out in the market and bidding up the price of deposits and making additional risky loans? What's the administration's position on that? Should the FSLIC put a stop to that, slow down the growth, or should the FSLIC do nothing? What's the administration's position?

Mr. GOULD. One, you try to resolve as many as you can. In this case, it's two a week.

Senator **Heinz**. The question is first aid before you bring people into intensive care to "resolve" the problem.

Mr. **Gould**. Growth without capital should be stopped. I agree with Mr. Sandler. One of the worst phrases around is "let's grow out of the problem." It doesn't usually work.

Senator **Heinz**. That answered my question. Thank you.

SHOULD HEALTHY THRIFTS BE ALLOWED TO LEAVE THE INDUSTRY?

Now, gentlemen, one of the issues we're going to be confronting again soon is the extent to which thrifts should be allowed to leave the industry and sign up with the FDIC. Do you favor or oppose allowing healthy thrifts to leave the industry?

Mr. **Sandler**. What you have is a counterproductive incentive. You have people who are forced to stay——

Senator **Heinz**. We all know what the incentives are. You don't have to be a genius to figure that out.

Mr. **Sandler**. What you're saying is that institutions that have the requisite net worth are forced to be in a system in which they are competing with institutions in another system which have a lower cost base simply because they're insured by a different agency.

Senator **Heinz**. I understand that. The question is, what policy do you favor?

Mr. **Sandler**. They should be let out.

Senator **Heinz**. They should be let out?

Mr. **Sandler**. Sure.

Senator **Heinz**. Now if we should let healthy thrifts out because the industry is considered to be troubled because there might be higher insurance costs imposed upon it at some point, what does that mean for the future of the thrift industry? Does that mean ultimately we don't need a thrift industry?

Mr. **Sandler**. I think my testimony was to the point you do need a thrift industry because we have done a better job of taking care of housing Americans than anybody else. The issue is not the industry. The issue is not those of us who are making residential loans. The issue is the FSLIC fund. That's the issue and it has nothing to do with the fact that we are committed to housing whether we're a member of FSLIC, FDIC or any other initials we create. That's not the issue.

Senator **Heinz**. So perhaps what you're saying is simply close down the thrift industry as we know it today, let the taxpayers bail out the depositors, and let the healthy institutions alone and go into business as part of the FDIC. Is that what you're saying?

Mr. **Sandler**. No. I think the answer is a little bit more complicated. I think you can use any one of several methods to solve the problem of FSLIC. Whether you combine them or don't combine them, different people may see different advantages or disadvantages. You have a much larger problem, as Members of Congress, and that is, what is the nature of the insurance depository system, how does it work in a deregulated environment? Is flat-based insurance compatible with deregulation? What kinds of bells and whistles do you have to put on the system? Can it work at all and, if so, how can it work? This is a minor problem.

The large problem is get rid of—what I'm concerned about is that as long as we sit and frankly fiddle, $6 to $10 billion in costs are being added every year and I'm not making these numbers up. These numbers come from Federal Home Loan Bank Board analyses, on the low side. But even if it's only $6 billion a year, it's adding up. You've got to act. You can go either way.

Senator HEINZ. Now Mr. Gould says that he thinks—and he may correct me if I misinterpret what he said—Mr. Gould says that the Bank Board is going as fast as they can realistically go. Is that right, Mr. Gould?

Mr. GOULD. That is what they have convinced me. They have told me that they are resolving cases as fast as they organizationally can.

Senator HEINZ. Now you gentlemen obviously do not feel that way. Who is right and why?

RESOLUTION OF CASES BY BANK BOARD

Mr. LEVY. This is an interesting point because we're sort of in a Catch-22. The argument that I was making 2 years ago and 1 year ago during the recap discussions was that the pace of case resolution dictated the amount of money that you had to put on the table over the time period and that I called for congressional oversight that they couldn't spend more than $8 or $10 billion, whatever that number is. I agree totally with what the Under Secretary is saying. The pace of resolution by itself is very slow. You're dealing with people at the Board that are going through careful analysis. Every time they announce a case resolution everybody jumps in to criticize. So there's a fear of putting the resolution on the table, so you get a process that by the very nature is slow. The chairman I'm sure would like to go faster. Our whole point in the recap wasn't that we thought it was a $5 billion problem, but we thought they couldn't speed up the process, so better to have a number out there that would relate to the speed of the process and that could be subject to oversight as time went on.

Senator HEINZ. My time has expired.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Mr. Chairman, I have a statement which I would like to ask unanimous consent to have inserted in the record.

The CHAIRMAN. Without objection, it will be printed in the record in full.

Senator GRAHAM. In conjunction with that, I'd also like to ask for an item which appeared in the July 16 Economist to also be inserted in the record.

The CHAIRMAN. Without objection, it will be inserted in the record.

[The complete prepared statement of Senator Graham follows:]

STATEMENT OF SENATOR GRAHAM
AUGUST 2, 1988

- THE CRISIS FACING THE THRIFT INDUSTRY IS TOO IMPORTANT TO BE HIDDEN IN THE SHADOWS OF INDIFFERENCE ... OR TO BE DEFERRED TO AVOID POLITICAL ACCOUNTABILITY.
- ONE OUT OF SIX INSTITUTIONS IS LESS THAN SOLVENT.
- THE INDUSTRY IS SADDLED WITH BILLIONS IN INDEBTEDNESS, AND THESE LIABILITIES FAR EXCEED THE INSURANCE COVERAGE AVAILABLE THROUGH FSLIC.
- CONGRESS HAS LOOKED TO THE EXECUTIVE BRANCH FOR LEADERSHIP ON THIS ISSUE, AND WE HAVE BEEN WOEFULLY MIS-SERVED.
- THOSE WHO WOULD DEFER DEALING WITH THIS CRISIS UNTIL 1989 CANNOT CLAIM TO BE RESPONSIBLE STEWARDS FOR THE MILLIONS OF DEPOSITORS WHO RELY ON A SOUND THRIFT SYSTEM.
- THESE HEARINGS SHOW THAT CONGRESS WILL RE-ASSERT ITS RESPONSIBILITY TO ASSURE PUBLIC TRUST IN THEIR SAVINGS AND LOANS.
- BE ASSURED THAT THE PUBLIC DOES AND WILL HOLD US RESPONSIBLE FOR STEWARDSHIP OF THE THRIFT INDUSTRY.
- NEXT TO THE FEDERAL DEFICIT AND THE TRADE IMBALANCE, I CONSIDER THE THRIFT CRISIS AS THE BIGGEST ECONOMIC ISSUE FACING CONGRESS.
- MR. CHAIRMAN, MY QUESTIONS TODAY WILL BE AS FOLLOWS:
    1.) WHAT IS THE STATE OF THE THRIFT INDUSTRY, AND WHAT IS THE TREND LINE FROM THE IMMEDIATE PAST TO THE NEAR-TERM FUTURE?
    2.) WHAT FACTORS LED TO THE CURRENT PROBLEM?
    3.) WHAT STEPS SHOULD BE TAKEN IMMEDIATELY -- BY THE 100TH CONGRESS -- AND WHAT STEPS SHOULD BE TAKEN IN THE EARLIEST DAYS OF THE 101ST CONGRESS TO ASSURE PUBLIC CONFIDENCE.
- MY ANALYSIS OF THIS PROBLEM IS THAT WE'VE CREATED A MISMATCH BETWEEN PROFIT AND RISK.

- THIS WAS RECOGNIZED IN THE JULY 16 ISSUE OF "THE ECONOMIST," WHICH NOTED THE SIMILARITIES BETWEEN THE AILING FSLIC AND THE THREATENED FDIC.
- MR. CHAIRMAN, I'D LIKE TO QUOTE FROM A KEY PASSAGE FROM "THE ECONOMIST,":

> If the banking industry's problems are not yet nearly as bad as the thrifts', where the FSLIC is bust and the cost of liquidating the insolvent thrifts is put at about $70 billion, they are both suffering for the same reason -- America's flawed credit system. The combination of deposit insurance and financial deregulation has proved to be a formula for overindulgence in lending. The incompetent and the imprudent have been able to bid for deposits based on subsidised credit in the form of the federal government's pledge to bail out insured depositors.

- WHEN WE SET UP A SYSTEM THAT PRIVATIZES GAINS AND SOCIALIZES LOSSES, IT'S BOUND TO PRODUCE PROBLEMS.
- ANY TOUTED SOLUTION THAT DOESN'T ADDRESS THIS FUNDAMENTAL MISMATCH IS MERELY COSMETIC.
- MR. CHAIRMAN, NOW IS THE TIME TO COME TO GRIPS WITH THIS CRISIS, AND I LOOK FORWARD TO PRODUCTIVE HEARINGS TODAY TO BEGIN TO TAKE US IN THAT DIRECTION.

current problems of the banking industry in Texas. 40 banks there have failed so far this year. The FDIC has already spent $2 billion supporting Texas' two largest banks, First Republic and First City. First Republic will require more money while BancTEXAS, which the FDIC helped rescue last year with a $150m cash infusion, is back in trouble. Banking analysts reckon that the FDIC will be lucky if it spends less than $7 billion bailing out the big Texas banks. First Republic alone, by the FDIC's own reckoning, will cost $4.5 billion up-front, the same amount it had to come up with in 1984 to bail out Continental Illinois.

The loan star state's economy is not recovering as fast as the optimists expected. Oil prices continue to slither, while the local property market remains depressed. There is no market at all in second-tier office space. Texas's six largest bank holding companies had at the end of 1987 total assets of $74 billion, around 30% of which were in property-related loans. So a not inconceivable write-off of 20% of these assets would cost $14.8 billion. As Mr Dennis Jacobe, chief economist at the United States League of Savings Institutions, has written: "Texas alone could sink the FDIC".

Recession or no recession, the FDIC's finances will not be improved by the severity of the present drought. That is hurting farm banks just when the sector was thought to be recovering after several years of slump.

If the banking industry's problems are not yet nearly as bad as the thrifts', where the FSLIC is bust and the cost of liquidating the insolvent thrifts is put at about $70 billion, they are both suffering for the same reason—America's flawed credit system. The combination of deposit insurance and financial deregulation has proved to be a formula for overindulgence in lending. The incompetent and the imprudent have been able to bid for deposits based on subsidised credit in the form of the federal government's pledge to bail out insured depositors.

In these circumstances the FDIC's policy, just like the FSLIC's, has been to defer the problem by so-called "failure management". Because the FDIC sees the problems facing it growing, it is eager to find buyers of bust banks so that it can defer the cost of liquidating them out of its own declining cash reserves. It can only do this by offering huge incentives.

The problem, as the FSLIC's example has already demonstrated, is that "failure management" tends to solve smaller problems today at the risk of bigger problems tomorrow. The FDIC already has examples, such as the purchase of the failing Interfirst Corporation of Dallas by First Republic in June 1987. Less than one year later First Republic is a ward of the FDIC.

Now Citicorp, among others, is looking at First Republic with a view to a federally assisted purchase. These deals can make sense for the acquiring bank. Instead of paying a premium to buy a good bank, a bank like Citicorp is paid by the FDIC to take over a problem like First Republic. The deal does not generate goodwill, which would have to be written off against capital. Instead the acquiring bank pays, say, 75% of net asset value and the FDIC provides the other 25%. The bank can then immediately write the assets down to the 75% it paid. Anything extra goes back into the bank's capital.

If the deal can make sense for the buyer, that is only because of the large amount of risk retained by the FDIC. The harsh truth is that the FDIC, with its finite resources, is being asked to deal with problems not only beyond its capacity but also outside its original ambit—such as a regional property depression.

Senator **Graham**. Mr. Gould, one of the statements I made in my unread opening statement was that the first question is just what is the extent of the problem and you have indicated that you think it may be half the problem that some others feel it is.

Assume that the problem—well, let me ask a preliminary question. What is the Treasury doing to arrive at an assessment of the extent of the problem?

EXTENT OF THE PROBLEM

Mr. **Gould**. Well, sir, our major dependency has been upon the General Accounting Office as the arm of Congress and upon the Bank Board as the regulator. Those have been the two driving numbers that we have worked with.

We have also had conversations with other regulators for any insight they could give us.

Senator **Graham**. So the answer is, you are not doing any independent analysis to arrive at the answer to the question of what is the extent of the problem?

Mr. **Gould**. No, sir. From the very beginning, we have said that we have no facilities to go around to each S&L and appraise its portfolio.

Senator **Graham**. Assume that the problem is on the low side, a $30 billion problem. What do you believe Congress should do between now and our adjournment in October?

Mr. **Gould**. Well, in my opinion, Senator, if you believe that that is the size of the problem, and as I do, that the Bank Board is moving as expeditiously as it is organized to do, then I think it is not necessary to do anything between now and November.

If you proceed into next year at the rate of two resolutions a week you're going to learn something about the costs. Then if you want to review the situation again next year, I would suggest and really ask very strongly that you do it in the context of looking broadly at the whole public policy issue of the role of deposit insurance.

Senator **Graham**. The second question in the same vein, is if the problem is of the high side of the envelope, a $70 billion problem, what do you think Congress should do in the next 60 days?

Mr. **Gould**. Well, I don't think you ought to appropriate $70 billion because I think it's going to require a lot more analysis.

Senator **Graham**. Affirmatively, what should we do? An affirmative answer would be nothing?

Mr. **Gould**. If I believed it were $70 billion, I would consider something like I believe this committee has already passed—a commission to come back very early in the next year. I thought in my reading of it that was a good commission blueprint because it's quite broad, and if it's $70 billion you've got to look broadly at this.

Senator **Graham**. So the answer is under any scenario—low side or high side of the problem—you believe for the next 60 days—that is, for the duration of the 100th Congress—that the appropriate response is no response?

Mr. **Gould**. Would you give me a moment to try to clarify that? Conceptually I think this is the way you should look at it.

FSLIC is a workout fund. It's not an insurance fund. It doesn't have enough money in it to be an insurance fund. It won't have enough money in it to be an insurance fund. It's a workout fund for troubled thrifts.

You gentlemen are the insurance fund and as long as you remain, as the chairman said in his opening remarks, telling the depositors that they are secure, then I do not see that you have to work out anything between now and November.

Senator **Graham**. The question I asked was not what should FSLIC do or the Home Loan Bank Board. I asked what should Congress do, accepting the fact that we are ultimately responsible.

Mr. **Gould**. The only problem you're going to have or the only "crisis" that could occur between now and the opening of Congress next year would be deposit related. In my view, there is enough money to continue down the path they are on. As long as Congress stays behind the depositors, then I think there's time for a commission or a group or a study. If the problem is $70 billion, I think a study would be a very good direction to go.

Senator **Graham**. Mr. Chairman, I'd like to ask each of the panelists to respond to the question of what are the options for long-range resolution of this issue. I have seen at least four separate steps that could be taken. One is to recant Federal obligation as an insurer of these deposits. Second is a taxpayer-funded appropriation to the fund sufficient to meet its obligation. Third is to look within the thrift industry to the net worth of all of the institutions to create a pool sufficient to fund the insolvent institutions. Fourth, to look at all financial institutions through some form of merger of FSLIC and FDIC for a pool of funds sufficient to meet the obligation. You may have some other options that you would like to add.

Of those or any additional ones, which would you recommend we ought to look to?

The **Chairman**. This is a long question. I hope you can give us a fairly concise answer. Your time is up.

OPTIONS FOR LONG-RANGE RESOLUTION

Mr. **Shackelford**. You are going to have to look at a total revision of the deposit insurance system which will involve a lot of debate and hearings and some kind of combination of funds. The private capital resources are totally inadequate to do the job.

Mr. **Sandler**. Clearly, you can't recant the Federal obligation. No. 2, if you look within the thrift industry, the total net worth of the solvent institutions is $38 billion. How do you fit $38 billion into even $30 billion or $50 billion or $60 billion. It would render the rest of us insolvent. The FDIC combined with that still isn't enough, in my opinion. You may decide to allocate among those as to the rest of the money, but you're clearly going to have to face reality because the size requires taxpayer funds. Just incidentally, as I might add, Congress allocates taxpayer funds right now to assist the banking system.

Mr. **Levy**. I'd like to hear the Under Secretary respond to that. One of the first tenets of the program is stopping growth of problem institutions. If you look at page 42 of our statement, Columbia

Savings just in the last 60 days took a $2.8 billion institution with no capital—negative capital—allowed them to get into a transaction of $1.5 billion and, even worse, one of the leading attorneys in the savings and loan field has distributed a memo to his clients saying the fact that growth was determined to be a permissible part of First Columbia's plan may give institutions some insight into the present balance sheet restructuring techniques that the current Board is prepared to condone. I think you could do a great service between now and the next administration in sending a message that says we just can't have these growth plans, that can't be part of the solution at this point. Case resolution will go on at its pace, but we must stop growth by insolvent institutions while all this is happening.

Senator GRAHAM. Could Mr. Gould respond to the question of which of the options he——

Mr. GOULD. Well, we can't recant the Federal guarantee. We would all want to be on another planet the day that hit the banking system as a whole.

I think you can take steps to make sure that the problem doesn't get worse in the interim, to the degree that that can be done, whether it's by limiting growth of insolvent institutions, or whether it's better control of those institutions having problems. Clearly, the FDIC and FSLIC merger is not going to add that much in terms of "surplus" funds. That's not realistic. I agree with Mr. Shackelford that when you really look at this, as I say again, please include the whole issue of deposit insurance because it is one of the main factors that has driven what has occurred here.

The CHAIRMAN. Senator Graham, I want to congratulate you on your questions because I think it's very important that we distinguish where we're talking about what can be done in the long run and what can be done right now and what should be done now and I feel very strongly—and I take it that this panel does, too—that we should take action now, not in the next Congress, not when we come back, but now, to do what we can to stop the present bleeding.

Now you all agree—Secretary Gould has agreed with you three gentlemen that we should stop any growth by institutions that don't have capital. Perhaps we should go farther than that and stop any growth if they have capital of less than 1 percent or 2 percent or something of that kind.

Now that seems to me to take some kind of action probably by the Congress. I'm not sure whether it does or not, but we should make sure that it's done and if it will not be done by the regulators then the Congress it seems to me has to step in and act.

But there's something else that we should do. It seems clear to me that we have a situation where some of these institutions which are of course federally insured—95 percent of their liabilities are insured—are operating on very loose regulations from States. Why shouldn't we now provide a provision that in the future any institution that is going to be insured by the Federal Government—I don't know exactly how to frame this, but any institution that is going to be insured by the Federal Government must conform with Federal determination as to what kind of investments they can make, the risk involved in the investments they can make. In other words, they can't get into equity. They can't get into real estate and so forth. They can of course make residential loans and so on.

It seems to me that we should do that now because there's a billion dollars a month, as Senator Riegle has so well pointed out, bleed here and we simply can't afford another $6 or $8 billion before we get back next year. How about that, Mr. Levy?

Mr. LEVY. Well, I would suggest that you have to take a broader look. We are taking a look at specifically that question.

The CHAIRMAN. Well, just answer on the urgency. Should the Congress—I've got legislation I've introduced. Should we try to call it up before this committee, report it to the floor, press for action on the floor and in the House and try to get legislation passed this year?

Mr. LEVY. I think that's part of a broader study that Mr. Shackelford refers to that the Treasury Secretary refers to. I think that has to be looked at, but don't lose sight of the fact there are some things in Federal law that raise questions.

We haven't even discussed it today, but the ability to make loans——

The CHAIRMAN. You say looked at. Now I get the impression we shouldn't do it.

Mr. LEVY. I'm saying you're talking about broader reform. That isn't going to happen. I'm saying there should be a broad look at it because there are problems within Federal law. The ability to make loans up to 100 percent created massive problems in the 1982-84-85 period. I think you've got to look at the powers granted and see the kinds of exposures that they present to institutions and review the whole process. I think the question of whether you pass that piece tomorrow or whether that's a piece that goes in in January is not relevant.

The CHAIRMAN. Well, I'm not going to be here next year. Don Riegle or Jake Garn is going to be chairman of the committee and you probably will have much more efficient operation at least at the committee level here, but I don't think we should wait until then. The burden is going to be heavy on them next year. Why not act this year? Why not act now? This is a very urgent situation. Why shouldn't we move on it?

Mr. LEVY. Because I think that in focusing on risk we have to look at where risk can be assumed in dramatic and rapid ways. Somebody asked earlier about the regulatory process, the examiners. We have a lot of examiners. We've gone from 600 or 700 to over 2,000. I think we fixed that part of the problem. They're out there.

But understand how this risk arbitrage works. Picking up—if they get a business plan approved on growth, one telephone call, a 5- or 10-minute call to a Wall Street firm can put that kind of arbitrage in place. It happens overnight. This isn't something dealing with State powers.

The CHAIRMAN. Let me ask Mr. Sandler, I'm missing something. You feel very strongly on this. You've given us one of the most emotional and effective presentations I've heard in the 30 years I've been here and you certainly know this business backward and forward.

Should the Congress try to act within the next closing months that we're in session?

SHOULD CONGRESS ACT BEFORE THE END OF THE SESSION?

Mr. **Sandler**. You're absolutely right. It's a serious problem. The problem is, can you get the votes on something like that because everybody will immediately scream "States rights." The California law is an inanity. It should never have been passed and it's the cause of many of the problems. You're right. Mr. Levy is also right. There are things right now that are wrong in the Federal law. He gave an example of something which causes as much problems and as much loss as the insane California law.

The **Chairman**. Would you say we should move as fast as we can?

Mr. **Sandler**. You should try.

The **Chairman**. In the areas where there's clear agreement. Secretary Gould has pointed out that we should not permit growth by insolvent or semi-insolvent institutions, for example, and it seems to me it's certainly wise also to require that if people are going to be federally insured they comply with Federal standards.

Mr. Shackelford.

Mr. **Shackelford**. I think it's very difficult for the Congress to regulate because you get into a lot of subtleties and that kind of thing. Stopping the growth, in my judgment, could be done without need for congressional action. If people wanted to do it, they have the power to so do now.

The **Chairman**. How do we get that done?

Mr. **Shackelford**. I don't know how things work in this community, Senator. I think you just call guys and tell them to do it.

The **Chairman**. My time is up. [Laughter.]

Mr. Gould, did you want to respond, not on Senator Garn's time?

Mr. **Gould**. I was just going to say the only modification I would make to your suggestion on State law versus Federal insurance fund is that there may be State chartered institutions whose capital base is so strong that it might be not that risky to have them proceed. I think some discretion should be left with the regulator. We addressed this in 1986 and we were concerned about the States being much more liberal than the Garn-St Germain Act. We have one solution. There are others. But I think there should be some regulatory discretion where someone is capital strong. What I think we're really all talking about here, Mr. Chairman, is not having people speculate with the insurance fund's money. Capital is the cushion between the insurance fund and those activities.

The **Chairman**. Senator Garn.

Senator **Garn**. Thank you, Mr. Chairman.

Gentlemen, the chairman has just emphasized a point that I've come to agree with him on totally. As one of the most ardent supporters of States rights, I am sick and tired of sitting listening to people try to blame this problem on deregulation at the Federal level. Ten percent in commercial loans is not a problem. What California and Texas and other States have done is a problem. If we made any mistake it was in not making a policy decision a long time ago that anybody that wants FSLIC insurance must comply with Federal standards.

You may have some problems with Federal standards, but compared to mushroom farms and all of the things allowed by States, the Federal law is very tight, relatively speaking. And so I've come full circle. This is a point where you ought to override State law and tell these people they cannot have Federal guarantees if they're going off in these very, very risky investments.

Mr. Sandler, you used the term piddling. That gets me back to my major point again and once again I'll say—and I'm sorry Senator Riegle isn't here because he didn't hear the first part of my statement saying I agreed with much of what all of you had to say. He only hears the part where I'm defending Congress and then he has to leave again. But the point of it is—and I don't know how you quantify it—I'm a little bit tired of talking about numbers. Whether it's $30 or $70 billion, it is one heck of a problem. I don't know why we continue to have hearings and argue over what the size of the problem is; $30 billion is a disaster. The bigger it gets—that's like telling me that I have a million dollar debt instead of $200,000; $200,000 is just a big a problem for me as a million. It doesn't make any difference whatsoever.

So we start arguing about that number rather than talking about solutions and looking at the genesis of the problem. Now if we're handling two cases—there's no doubt the Federal Home Loan Bank Board has been piddling because they didn't have the resources to close them. Maybe they could have done something about growth, but they didn't have the money to close them down. As soon as that money was available, the rate increased dramatically. Again, that is not a matter of opinion. That is a matter of fact. They are closing two a week, some weeks more than that, but averaging two a week.

We delayed because the House of Representatives would not go along for 11 months—44 weeks times 2 is 88 more institutions that would have been closed if you can make that assumption. Now that wouldn't solve the problem, but it certainly would have helped with a lot of institutions that every one of us know were being carried—everybody knew what condition they were in. There was no means of shutting them down. That's why I have to keep going back to an administration that was begging in the spring of 1986 to do something, a Congress that wouldn't do something, and a House of Representatives that wouldn't do something without extracting a housing authorization bill for it. The House of Representatives was so irresponsible that if you're not aware of it, not only would they not pass any FSLIC recap in October 1986, they refused to extend the emergency provisions of Garn-St Germain, title I and title II. So we left office in October 1986 or left the session not only not giving regulators new powers and new money to try and work on this problem, we took away the existing powers. And I think Congress' unwillingness to act in 1986 is highly significant. It would not have solved the problem if they had done everything that was asked for, but it certainly wouldn't be as big a problem.

Do you agree with that?

Mr. LEVY. To whom are you addressing that, Senator?

Senator **Garn**. Well, I'm asking Mr. Sandler first. Mr. Levy, I'll give you a chance to answer it. He's the one that used the word "piddling."

Mr. **Sandler**. Senator, the delay of the House was wrong. Clearly the forbearance was wrong. I was one of those individuals, together with others, who were arguing strenuously against what was a nonsensical suggestion by the U.S. League. Let's put that on the table.

But I believe, sir, that you're making exactly the same mistake today because there is a big difference between $30 billion and $60 billion. Thirty billion dollars makes you think that you can really solve the problem by taking a billion dollar excess assessment a year from the industry and if it's $60 billion you would understand that you can't, and by failing to act, you're causing another loss of $6 billion.

Senator **Garn**. Well, when I tried to get FSLIC recap, the problem of $6 billion a day grew to $10 billion a day before we finished. Now the difference in our opinion is you're asking for an immediate taxpayer bailout.

Mr. **Sandler**. No, sir. What I'm saying is——

Senator **Garn**. That's the only alternative we have right now with trying to solve it. I won't vote for a taxpayer bailout. I didn't vote for a Chrysler bailout to make Lee Iacocca a national hero. He did that on the back of Federal funds.

Mr. **Sandler**. With all due respect, Senator, what it does mean if you won't allocate the $60 billion now, you're going to have the problem next year except it's going to be $75 billion and I could demonstrate that. I can prove it to you.

Senator **Garn**. If it is $75 billion, I'm still not going to ask the taxpayers of this country to bail out fraud and mismanagement and abuse of managerial power from people who went crazy in investments that they should not have been in because of State legislation.

Mr. **Sandler**. And you're accepting the fact that——

Senator **Garn**. I've got to play O.J. Simpson to get to the floor.

Senator **Graham**. The chairman has asked me to recess until we return from this vote. We will continue in approximately 10 to 15 minutes.

[Recess.]

Senator **Riegle**. If I can invite everyone who wants to be in the room to take your seats and while the vote is on I'll resume the hearing because I'm next in the order of members asking questions. I assume Senator Proxmire will return shortly and perhaps others as well.

Mr. Gould, we were in a bit of an exchange before and then our time ran out. You mentioned an FDIC study. Are you aware of an FDIC study?

Mr. **Gould**. I have not seen an FDIC study. I have had discussions with FDIC Chairman Bill Seidman. I know he's doing a very broad study which I assume is some months off on deposit insurance and the whole kind of review of the financial system. I am aware that Mr. Seidman is testifying tomorrow in the House and that the FDIC has looked at some analogies of banking costs where they close them down vis-a-vis an S&L. But I'm not aware of any specific numbers they're using nor of any study specifically directed at the S&L's.

Senator RIEGLE. Just to make that clear for the record, you mentioned it before in passing. You are not aware—you are not personally aware of any study they have done or any preliminary results that they have developed? That's your testimony today?

Mr. GOULD. Yes, sir. I have not seen any such study. I know they have been looking at it in response to questions from the House Banking Committee. Indeed, I have met with Mr. Seidman as recently as yesterday.

Senator RIEGLE. Now you said to me in response to my question before that you know of no credible person that says that the exposure is $100 billion. I mean that was sort of a strange number to my ear because you obviously took a very high number to say that. Do you feel the same confidence if the figure is $50 billion?

Mr. GOULD. Well, I took the $100 billion frankly out of the press. I didn't invent it myself.

Senator RIEGLE. But we're not using that number—I haven't heard that number used here by anybody today on that table or at this one.

Mr. GOULD. Are you saying do I think $50 billion under some circumstances could be credible?

Senator RIEGLE. Yes.

Mr. GOULD. Yes, sir. I think under some circumstances that could be credible.

Senator RIEGLE. In terms of actual losses today?

Mr. GOULD. I don't want to get off too far, but much of the problem we've had in the banking system—S&L's and commercial banks—in the last few years has basically been a byproduct of commodities disinflation, for example, farm crops or the price of oil. I find it very difficult to predict the future price of oil, but I could see conditions in the Southwest that, yes, could result in a higher number if there's no economic recovery there if the price of oil deteriorates further.

Senator RIEGLE. Let me ask all of you this: we talked here about the possibility of trying to do something this year, and that's difficult to do. It's not impossible. I think we should try.

Now it seemed to me that there was general agreement on the notion that savings and loans that are insolvent ought not to be allowed to grow further at this point, and I take it that that's your position, Mr. Gould?

Mr. GOULD. Yes, sir; it is.

Senator RIEGLE. And I take it that your colleagues here from a different vantage point would also agree with that, that insolvent S&L's should not be allowed to expand.

It seems to me whether that's done by regulation or whether it's done by administrative direction to the regulators or whether in fact it takes a Senate resolution, that that's one thing that we ought to be able to nail down after today and that we ought to be able to stop it.

MINIMUM CAPITAL STANDARD

Should we try even now to set some sort of a minimum capital standard on a generally accepted accounting basis so that we're not just repackaging failed operations that are almost certain to fail in the future? Shouldn't we have some minimum requirement with respect to real money that somebody's putting on the table and putting ahead of Uncle Sam and the taxpayers so that if there are going to be losses in the future the losses come out of the private capital first and there's an incentive there to avoid the losses for that reason? Shouldn't we also require that in any mergers or workouts here that if somebody is going to be brought into this scheme they must put real money on the table? Mr. Gould, shouldn't we do that?

Mr. GOULD. I think that's the ideal, Senator. In my conversations with the Bank Board, I have found very often they have answered that by saying, "We made the best deal we could."

Senator RIEGLE. But if you make the best deal and it's a bad deal, why would we want to do that?

Mr. GOULD. Well, it is a better deal than what is prevailing at the moment, say a merger of three firms in which the capital is created by a note from the FSLIC. You can't say, well, that's outside capital, but you can say that consolidation could reduce overhead costs, and it could reduce the ongoing losses that Mr. Sandler was talking about. It's fine to say we ought to have more capital. The administration has been saying that for several years. We said it in both the commercial banking and the S&L industry, but if you can't get people to put that capital up, then I think you have to look at what else you can do. Surely capital related to growth, which Chairman Gray tried to implement, is certainly the right direction.

Senator RIEGLE. Mr. Sandler, did you want to comment on that?

Mr. SANDLER. Of course, the idea of taking companies which have no capital and permitting them to acquire insolvent companies is frankly insane public policy and is guaranteed to result in larger losses. This can be a case where loss one plus loss two is going to equal to loss six. You're guaranteeing—and what's worse is that it's going to continue to distort the market. They can be operating without capital, paying higher than market rates, they will get some benefits from consolidation, but they will definitely distort the market. We don't understand why that's being done. I don't understand why pressure is being put on the Federal Home Loan Bank System to accept unsecured notes of FSLIC. That's tremendously mischievous. And that's the kind of thing, if you were to speak out, that you ought to stop. You ought to stop that. You ought to stop these insolvent companies without capital acquiring other insolvent companies. You ought to be giving some direction on how much junk bonds S&L's can invest in—the banks can't invest in junk bonds. How in God's name do companies with a history of residential lending know something about junk bonds? The thing that Jerry Levy talked about, mortgage derivative securities. What kind of control will you be putting on that? There are so many things that can be done now that aren't being done.

Senator RIEGLE. Let me ask you this. Mr. Chairman, I was just going down through the list of your ideas of what we might still do this year. What are the things that can be done either by regulatory direction or by a sense of the Senate or congressional resolution or whatever?

Should consideration be given to saying that—the chairman has spotlighted this problem and many of us are concerned about it—States cannot allow these expanded activities while we put the Federal taxpayer and Federal deposit insurance on the hook. Should we say that any growth in State granted activities that's based on Federal deposit insurance ought to be put in a kind of moratorium status until such time as we unwind this problem? In other words, why should we continue to allow growth in that area? Now that's arbitrary because some may use it well and some may use it poorly, but until we line up the Federal deposit guarantees with federally granted authorities, why should we allow State granted authorities to continue to run at large?

Mr. LEVY. I think that's an important point and I come back—it isn't simply a case of saying all powers granted by the States don't make sense. We come from a State that has a tangible GAAP net worth average in the State of almost 6.5 percent. We have a very permissive statute. We have a very strong level of supervision and regulation within the State. To cast it out, there are going to be a lot of people who are going to be very annoyed with it obviously.

But let me go to the premise—I'm sorry that Senator Garn isn't here because there's some sense—as we talk about this problem and we say there's blame to be shared, let's understand something very clearly. Yes, some of these crazy powers granted by State authorities contributed to the problem, but let's not lose sight of where the losses are occurring right now. The losses that are being reported by these defunct institutions are real estate related, that—and I'm sure you'll explore this with Chairman Gray tomorrow—he identified fairly early on the embedded losses and the risk that was going on in acquisition, development and construction lending. Now couple that with in the Garn-St Germain bill we had an expansion to permit 100 percent loans, no equity, in the most risky type of lending available to savings and loans. That's what's unwinding today.

So to say that you're going to close the State powers, I just don't think that's where it is. I think that is part of the overall process in a reasoned and rational approach. Yes, the powers granted by the States should be studied and there should be a number of those things reviewed and seriously asked why there's an extension of Federal insurance, but just the blanket to accept the notion that that's where the risk is today, that isn't true.

Senator RIEGLE. I don't mean to make presumptive comments.

Mr. LEVY. We still have 100 percent loan authority out there and the question is why?

Senator RIEGLE. So you're suggesting that that ought to be changed, too.

Mr. LEVY. That was all they needed—10 percent was all they needed to self-destruct.

Senator RIEGLE. Mr. Chairman, my time is up.

The CHAIRMAN. Well, I disagree with you, Mr. Levy. I hate to say so in your last appearance and perhaps my last round of questioning, but I think that's where the trouble is. But we don't know but we ought to find out and find out in a big hurry where it is. As a matter of fact we should be able to determine that. But I'm convinced that certainly in Texas and California and some of the other States, the State chartered thrifts have been able to use the leeway that they've been given by their charter by their States to invest in areas that have resulted in enormous losses.

Let me ask you this, Secretary Gould. The bedrock problem for us is that this is an entirely different kind of a bailout than the others we've discussed. We have firmly promised the full faith and credit of the U.S. Government behind these deposits. You expressed your opposition to a taxpayer bailout in this case and so have other members of this committee. I haven't. But wouldn't you agree that there will be no alternative to a taxpayer bailout unless the industry itself can absorb it and that there is every reason to believe that the industry may not be able to absorb it?

NO ALTERNATIVE TO TAXPAYER BAILOUT?

Mr. GOULD. Well, I would add another qualification if I might, Mr. Chairman. We're taking a static view of this problem. It is possible that it could get better. If a lot of this, as Mr. Levy and others suggested, is a real estate related issue and real estate particularly in the Southwest improves, if the price of oil—which will have bad effects in other ways—if the price of oil went to $25 a barrel, I suspect you could see some of this improve.

The CHAIRMAN. You may be right, Mr. Secretary, but we've been hearing that song over and over and over again. It's the old story of just defer and wait and give us time and things are going to get better, they're going to improve. They haven't done it. You may be right about that, but it just seems to me that we ought to at least agree that if they do not, we are ready to move in, even though it's going to be a terrific hit against the budget, $30, $40, $50 or $60 billion—we have to do it.

Mr. GOULD. I'm not preaching forbearance. Indeed, I was on the other side of that argument. I'm saying that the size of the number could appear better—could. No one knows. Since no one knows, we must proceed ahead to the extent of our physical ability to do this with the funds available. If it is a $75 or a $100 billion number, no, I do not think the industry as presently constituted can afford to pay all of that. Might there have to be other sources of funds? Yes. How is that structured? I would suggest there are a number of variations and it should be done in the context of making sure that the taxpayers don't have to face it a second time, which is why I think you have to look at the role of deposit insurance which has enabled people to grow and speculate.

The CHAIRMAN. I would agree with that wholeheartedly, but I think there are just two alternatives. It seems very simple to me and the sooner we act, the better. If we keep postponing this, it's going to get worse and worse and worse. I think what we need is decisive action.

FINANCE

Federal Deposit Insurance Corporation

Banking on it

NEW YORK

THE problems facing America's credit system are not confined to thrifts (savings and loans) and their deposit insurance fund, the Federal Savings and Loan Insurance Corporation (FSLIC). The banking industry's insurance fund, the Federal Deposit Insurance Corporation (FDIC), is coming under increasing strain.

There are some 1,500 banks in FDIC care. This year another 200 casualties are expected, including the 87 which have failed since January. Mr William Seidman, the FDIC chairman, estimates that FDIC will lose $1.8 billion in 1988. That means the investment income earned from the FDIC's $18 billion of cash reserves is not expected to cover the cost of shoring up crumbling banks.

The big problem is the declining quality of the banking industry's loan book despite a more than five-year-old economic recovery. In 1986 and 1987, the commercial banks wrote off $32 billion of almost exclusively domestic debt, not including the over $20 billion provision for third world debt by American banks in 1987. That compares with the 30-year period between 1951 and 1980 when the industry wrote off a total of $28 billion.

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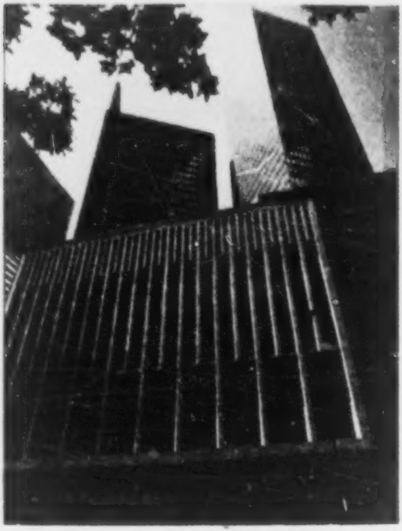
n 1982 and 1987, despite ecovth and falling interest rates, banks' annual write-offs rose billion to nearly $17 billion. Past shows that in a recession bank sually double or triple. So a seon could plausibly lead to banks $50 billion a year, more than us-DIC's $18 billion reserve.

if present trends continue, one se write-offs, representing a sum on-20 billion, would be concenng the weakest 20% of the banks. em, these banks can currently $16 billion of capital. So a bad uld wipe out the entire capital of 's weakest banks.

why, despite the expedient benefits to be gleaned from combining the two deposit-insurance funds, which is many congressmen's favoured painless "solution" to the thrift crisis, the FDIC is in no position to take on the problems of the savings and loan industry regardless of what happens on the third-world-debt front. Its own predicament is already serious enough.



The FDIC's biggest headache

Indeed, even assuming no recession, the FDIC looks vulnerable enough just with the

Let me ask you this, Mr. Shackelford. This is an entirely different question than we've had so far. You haven't been called on as much as you should because you're a very distinguished and able witness.

The Washington Post recently made this statement:

> The large and successful S&L's of which there are a good many operate very much like commercial banks. For that reason, they ought to be turned into banks and subjected to bank regulation. And those that can't qualify for bank charters, sorry, but they will have to be folded up. The financial world has become too dangerous for them and when they fail they become too dangerous to it.

How about that?

Mr. SHACKELFORD. My reaction—I know on the east coast a lot of people read that paper, but I think that there's a flawed premise in there. The more successful savings and loans have not acted more like banks. They have acted more like old time savings and loans. I think you'll have a lot of economists to analyze that. Therefore, pushing a housing financial regulatory system in a commercial banking format is probably to waste a couple more years of bureaucratic turf of "who am I going to work for" and I think, as everybody has elaborated, time is not our friend in this.

I would think if the Post means that the standards of capital which are supposedly increasing for the banks and should increase for us and more safety and soundness regulation, which I think the Bank Board is trying to push us to, if that is regarded as being like a bank, yes, they ought to do that. They ought to do everything that makes us a more safe, sound place for people's mothers' money.

The CHAIRMAN. Thank you very much.

Mr. Gould, the latest projection of the Home Loan Bank Board shows that the special assessment will be continued for another 10 years at a cost to the savings and loan industry of $18 billion. On the assumption that things do straighten out, as you indicate, do you think it's reasonable and feasible to continue the special assessment for the next 10 years?

SPECIAL ASSESSMENT FOR 10 YEARS

Mr. GOULD. Personally, Mr. Chairman, I consider that to be too heavy a burden on the industry. We have too much of a disparity, as has been suggested, between the FDIC and the FSLIC under those conditions there is a built-in incentive for people wanting to leave FSLIC and to go to the FDIC.

However, that helps to produce $42 billion roughly, according to the Bank Board's projections. If the size of the problem is larger, then I think the Congress is going to have to make the decision of how the burden on the taxpayer compares vis-a-vis the burden on the industry.

The CHAIRMAN. It seems to me that $18 billion is about the most optimistic possibility from everything we've heard. Maybe the people we've had as witnesses have not been accurate, but it looks—and you say that's too much of a burden on the industry, so it looks as if there's virtually no way that we can escape some kind of a hit against the Treasury.

Mr. GOULD. Well, the Bank Board's view of the size of the problem is in the low $30's—$33, $32 billion, if I recall correctly. The continuation of the special assessment helps to create $42 billion to resolve cases. One hope perhaps is that the last $10 billion is not necessary and that the special assessment can be phased down. Now if the number is going to be greater than that, then we're going to have to look at other sources.

The CHAIRMAN. My time is up. Mr. Sandler, why don't you respond.

Mr. SANDLER. $42 billion that Secretary Gould is talking about is going to be raised over 10 years. The problem is now. It's costing us $6 to $10 billion a year. If you want to present value the problem, present value it, but we're talking about a present value problem of $40 to $60 to $80 billion now and $42 billion coming in over 10 years. What's the present value of that? That makes, with all due respect, no sense.

The CHAIRMAN. Could you give us a comparison? What would be the present value of $42 billion over 10 years?

Mr. SANDLER. Half.

Mr. GOULD. Seven percent would be half.

Mr. LEVY. Just say this, that the interest on the bonds will eat up the premiums.

Mr. SANDLER. One to 2 years from now, in excess of one-half of the regular and special assessment will be going just to pay the interest on the FICO bonds.

The CHAIRMAN. So it is fair to say that even the most optimistic kind of appraisal indicates that there's no way the industry is going to be able to handle this?

Mr. SANDLER. Yes. And let me just add one thing. This $33 billion that we're talking about, the negative tangible GAAP net worth of currently insolvent S&L's is reported by the Federal Home Loan Bank Board to be $33 billion. That means if you put $33 billion into them, all you would have is 659 institutions with liabilities of $361 billion with a zero net worth. That's if you put $33 billion in. So how can you have a loss of $30 billion when you have tangible GAAP negative net worth of $33 billion? Please, somebody show me how it calculates.

The CHAIRMAN. My time is up, but would Senator Graham permit Secretary Gould to respond?

Mr. GOULD. I really would refer people to the cash flow situation of the Bank Board and I would point out that I am told by the Bank Board that built into that cost of resolution are yield maintenance provisions which are a good proxy for operating losses and that these kind of numbers that Mr. Sandler was just talking about are built into that. Now if someone wants to say the Bank Board's computer runs are wrong, they should have that argument with the Bank Board. Those cash flows are a pretty good indication of what they think will be available and year by year and are worth at least a starting point for conversation.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Mr. Chairman, I have this vision of a land mine. We don't know whether the land mine is a case of TNT or just one stick and has a clock that's ticking. Danny Wall has thrown his body on top of this. Mr. Gould has just put the Treasury on top of Mr. Wall's body, and now the rest of us, particularly those of us who have responsibility in the Congress, are being asked to put our bodies on top that bomb. I, for one, am looking for a way to get off of that pile and to defuse the bomb.

I'd like to ask a couple of additional items in addition to those that the chairman has listed as possible defusers.

One, FSLIC has moderated its use of the FICO bonds by issuing its own notes in lieu of those bonds. What is your comment on the prudence of that step and, if imprudent, what are some of the potential implications?

FSLIC NOTES

Mr. LEVY. Let me address that. They started out with a strong emphasis on use of the FICO bonds. Some time in May, late May or early June, they came out with a proposal to slow down the FICO bonding so they acknowledged that they would move to a position of slowing down the issuance of FICO bonds and to move to a dependence or reliance on the notes and they talked about possibly 7 or 8 year period before they got all the bonds out.

Within the last 10 days or 2 weeks, they reversed that position again and now they are back to wanting to go back to the bonds and away from the notes. So I think the situation has been very fluid.

Our position on the notes I think is very simple. The notes are being given to the institutions. They are being pledged at the Federal Home Loan Bank where they're monetized and the question is, will those notes be honored? You've got a problem in terms of people coming from the outside and putting up cash and receiving notes—public companies—and their ability to put those notes on their statement with an assurance that they will be honored. I've heard Senator Proxmire over and over again state that the depositors of this country are going to be protected because the Congress stands behind the commitment. Do they stand behind the commitment of the issuance of notes by FSLIC to the bank system? If that question were resolved, if Congress addressed that question, the notes could clearly be used. Why do they want to use notes? Because they can be issued at a lower rate of interest because of the tax considerations on the income flow from them and I think they're an excellent means of reducing costs. But they can only be part of the solution if they have the guarantee behind them. Otherwise, what we're really doing is we're exposing the $12 billion in capital in the bank system which is held in stock purchased by the savings and loans and if you remove the $12 billion in capital if those notes were not honored, you would in effect take the GAAP capital from about $31 billion down to $19 billion currently and the tangible capital would go negative. Remember that in this proposal we just heard about raising *x* amount—$18 billion over 10 years—it assumes a growth rate of over 7 percent a year. Institutions are not going to grow at 7 percent because they have to meet a 6 percent capital requirement and responsible institutions are going to be focused on building up their capital and one way to do it is to slow growth. So one of the flaws in the assumption that you would raise $18 billion is the industry is not going to go through the growth. We would end up with an industry of over $2 trillion in 1998 having spent everything with no additional capital.

Mr. **Sandler**. And that's assuming no further losses.

Mr. **Levy**. Exactly.

Senator **Graham**. A second issue is I think in your paper you used the term "Ponzie" scheme to describe the situation in which institutions must attract new deposits in order to cover their interest obligations to their current depositor base. I might say that if you'll stay here until 2 o'clock this afternoon we're going to have a hearing on Third World debt and we will hear some more about the need to borrow in order to pay interest on existing debt.

How many institutions are in this status of having to grow through new deposits in order to meet current obligations?

GROWTH THROUGH NEW DEPOSITS

Mr. **Shackelford**. That's a good question, Senator. I believe about 500.

Senator **Graham**. 500 are in that category?

Mr. **Shackelford**. That's our belief. We aren't really very well prepared on that.

Mr. **Sandler**. But that is a determinable number. It's not something that we may have at hand, but it's easily determinable and we can provide it for you.

Senator **Graham**. I am surprised frankly at the size of the number. I had been led to believe it was substantially less than that.

Mr. **Levy**. I wouldn't go as far as 500. Five hundred would pick up all GAAP insolvencies, but I think that clearly you could start with all the MCP's and I think there are 60 or 70 of those and you could go into the RAP insolvent institutions, institutions that are clearly the ones that we talk and some have expressed and described as the walking dead. Those institutions are out there having to borrow money in the marketplace daily. That's why we have something called agent program where the bank system has set up a program to attract funds from savings and loans to be funneled through to these problem institutions as a substitution of deposits so they don't have to go to the marketplace. But they're the ones that are driving up the costs in the marketplace.

Senator **Riegle**. Senator Graham, would you just yield? I know your time is up, but it seems to me that's another thing we ought to have on this list of immediate steps. We have to stop these institutions that have failed from going out and offering a premium interest rate and collecting additional deposits. Why should we allow that to go on for another day?

Mr. **Shackelford**. Except, Senator, the problem is, they've got to get the money to pay interest to their depositors, to pay the light bills, and to pay their employees. That's the Catch-22.

Senator **Riegle**. So are you saying there's no answer to that?

Mr. **Sandler**. Of course there's an answer to it. It's what Senator Proxmire is suggesting and what others are suggesting. Liquidate the insolvent companies that are causing the problem and instead of taking this one drip at a time, if Secretary Gould will excuse my repeating—piddling moneys into a problem that is too big, solve it now. If you want to assess the savings and loan industry, assess us, but assess us after you've solved the problem. It's kind of like a game. We're going to put the solution off and maybe it will get better. It's not going to get better. It's going to get worse because the operating losses are larger by three times than the total premiums we pay in. So how can the problem get better? What you've got to do is liquidate the insolvent institutions and get them out of the marketplace and then if you want to have the savings and loan industry pay $5 billion or $10 billion, whatever that battle will be, do it. But we're going about it the wrong way.

Senator RIEGLE. Thank you, Senator Graham.

Senator GRAHAM. My time has expired.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Are there any other suggestions that any of the four of you would make as a step that could be taken now and which would not just paper over this problem and dump it on the doorstep of the next administration and the next group that will be coming down the line in the spring of next year? Is there anything else that can constructively be recommended which can be done now?

Mr. LEVY. I hate to keep reemphasizing the point on the notes, but I think that if the notes carried the same kind of assurance of payment, I think you would have outside cash and outside investors, public companies, that would come forward wanting to invest, if they knew those notes were sound and solid.

Looking at the Southwest Savings in case No. 2 in the Southwest plan. We argued very, very strongly that in the assistance agreements it shouldn't be predicated on the Texas cost of funds. The Texas cost of funds tend to be the highest in the United States. Why not make it on the cost of funds nationally so that there would be no incentive—there would be an incentive—if they got 275 over the cost of funds, there would be no incentive for that institution to keep its deposit rates up. But they're being offered an assistance package of 275 over the Texas cost of funds for 5 years and then scaling back to 200. It's very attractive and I think if the notes were available with an assurance to these companies that they would be redeemed and that they were good paper, I think you would start attracting some outside money.

Senator RIEGLE. That's a specific suggestion. Does anybody else have one? I have another question.

Mr. SANDLER. Yes. In addition to what we call the quick fixes that we're talking about now, is get your study groups or whatever it is that you go through ready now. Let's not wait until January. If we wait until January, the problem will be dealt with in June or October and we will have lost another $4 to $7 billion. Let's do the work before the end of this session so that we're ready as soon as the new administration comes in to take action.

Senator RIEGLE. Mr. Gould, did you want to make a suggestion?

Mr. GOULD. I wanted to mention that the notes are scored by OMB as outlays from the Federal Government. They are recognized in that sense as an obligation of the Federal Government. I would also point out, and disagree if you wish with the cash flows in the Bank Board, but all of those are repaid out of the cash flows projected, making them good money. I just want to make sure that everyone knows that's what's meant, and that is a whole other discussion of how to create money beyond a certain level.

Senator RIEGLE. Let me ask you this. Why hasn't the time come for us to require that an auditing task force be put together from people from the Federal Home Loan Bank Board and other groups—whether they come from the FDIC or other places—and go out there and in a period of 90 days or 120 days nail down the size of these losses far more accurately than we have it today? I mean, part of it is catching up to the problem. Why shouldn't we assemble the auditing team we need so that we can go out there and really size this problem? Wouldn't you do that, Mr. Gould?

Mr. GOULD. Yes, sir, if I was sitting on an insurance fund in the private sector, I would want a better grasp than I have now. Again, I think it would be very useful. I think GAO should be involved. The Bank Board should be involved. But I think also that when the number is produced, one has to look very carefully at the premises and the assumptions involved because you can get all over the lot.

The CHAIRMAN. Would you yield just long enough for me to observe that none of this means I take it that we should wait until next year until we get a report—90 days, 120 days and then analyze the report and we don't do anything.

Senator RIEGLE. No, I'm not suggesting that at all. I think we can act on a number of things you have suggested and some other things as well, but I think the auditing team ought to be put to work immediately to track down these numbers. I think it's outrageous that we don't have that.

Mr. LEVY. Senator, you certainly could get closer to the number, but let me caution that what you're doing is you're taking a snapshot in time.

Senator RIEGLE. I understand that.

Mr. LEVY. You would have to go into each institution, reevaluate——

Senator RIEGLE. It's time we had a snapshot of this.

Mr. LEVY. A massive number of not examiners but you would need appraisers. You've got to go in and reappraise real estate. I talked with one of the academics that was referred to earlier who's on an MCP in Texas. Now they have no reason not to disclose all losses and he was astounded at the last meeting they came up with some assets and had to take additional 50 percent writedowns. It's a constantly changing thing. I agree totally with Secretary Gould. If we knew that the real estate there was improving—it doesn't show signs of improving—he's right, if oil went to $25, we might solve some of the real estate problems but I would ask what it would do to short rates and mismatches that those institutions have the problems might be so embedded that you're right back where you started.

But it's a task that could be attempted, but understand it's a massive job. You've got to go out and analyze real estate. The real losses out there are the questions of what are the present values of the real estate held in the portfolios.

Senator RIEGLE. The reason this has to be done is that the whole regulatory process has basically broken down. I mean, who wants to do it? The reason we're doing it is that we've got a problem that's spiraled out of control and now we've got to go out and try to at least capture the outer bounds of the problem.

Mr. **Sandler**. To the extent I understand Mr. Levy's point, I disagree. I do not understand how you can not go ahead and do that and if you don't have the manpower you borrow it from some other agency who does. It has to be done. He's right that you have to take it understanding the assumptions and all the caveats, but to not do it makes no sense to me at all.

The **Chairman**. Senator Graham.

Senator **Graham**. Mr. Chairman, just one last question of Mr. Gould. Mr. Gould, I understand you said that the FSLIC notes were being scored for purposes of outlays?

Mr. **Gould**. Yes, sir. They're a hit against the budget.

Senator **Graham**. It has surprised me in looking at the way in which the Federal deficit is calculated, there are a number of trust funds which are evaluated and counted in arriving at the Federal deficit. One of those is the FDIC trust fund. The FSLIC trust fund is not incorporated in arriving at the Federal deficit which is reported for Gramm-Rudman-Hollings purposes.

Mr. **Gould**. I do not think that is the case, sir. I think the treatment is equal for the FSLIC and the FDIC. Perhaps what has confused the issue is the FICO borrowings are a receipt for the FSLIC's purposes. They are treated, to my knowledge, equally the same for the budget.

Senator **Graham**. Assuming that I was right and you were wrong, would it be your recommendation that they should be treated the same way for arriving at the Gramm-Rudman-Hollings approach?

Mr. **Gould**. I see no reason to treat them differently, Senator.

The **Chairman**. Gentlemen, thank you very much. I think we have to be aware of the fact that the FDIC is in very serious trouble too. This will be the first year they've suffered a loss in the 55 years of history. This is something we have to be very concerned with because the same kind of problems that have hit your industry are likely to hit the commercial banking industry.

But your testimony this morning has been superb. It was obviously deeply felt and obviously very expert. Thank you very much.

The committee stands adjourned.

[Whereupon, at 1:10 p.m., the hearing was adjourned.]

FINAL OVERSIGHT HEARINGS ON THE SAVINGS AND LOAN INDUSTRY IN THE 100TH CONGRESS

WEDNESDAY, AUGUST 3, 1988

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD–538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Dixon, Shelby, Graham, Garn, Heinz, D'Amato, Hecht, and Gramm.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

Gentlemen, we welcome you. You are all esteemed and very able regulators. You know what your industry has gone through and I'm going to say something about that now.

Congress is on a crash course between an irresistible force and an immovable object. The irresistible force is underway because the Congress has pledged the full faith and credit of this Federal Government behind a trillion dollars of deposits in savings and loans in this country.

Until the 1980's, that seemed to be an easy commitment to keep. Total losses of the savings and loan industry during its 50 years of operation have totaled less than $700 million and the number of S&L's that failed each year in the 1970's averaged only about three. Federal Savings and Loan Insurance Corporation [FSLIC] seemed like the Rock of Gibraltar. It had multibillion reserves. It enjoyed a steady income from the 1/12 of 1 percent premiums paid by the Nation's S&L's. Interest income from its multibillion reserve brought in an additional income. The prospect that the Federal Government could be called on to rescue the FSLIC insurance fund seemed ridiculously remote.

Well, gentlemen, the 1980's have seen a nightmare for the savings and loan industry. From an average of three failures per year in the 1970's, the failure rate has shot up to 40 per year in the 1980's. This year failures will exceed 100. The industry's total losses for nearly 50 years ending in 1979 of less than $700 million has changed into losses that now exceed $1 billion every month.

This is so shocking that I must repeat it. The losses during the entire existence of the S&L industry until 1979 totaled less than $700 million. Today, the industry is losing $1 billion every month and the losses are rapidly increasing. Each year during the 1980's the Congress has been assured that the situation will turn around. The cry has been "Give us a little more time, give us a lot more credit, we'll grow out of it."

S&L's with very low or literally no capital were allowed to buy brokered deposits by paying interest rates above the market. Growth was childishly easy. Why not? All deposits were fully insured by the Federal Government. A depositor could put his money in an S&L with little or no capital in Texas, his deposits would be every bit as safe as if they would be in a conservatively operated S&L with a 10 percent capital base. The high flyers had in effect an engraved invitation from Uncle Sam to join a crap game where they couldn't lose. Think of it. They put little or none of their own money at risk. If the economy turned around, bingo. They make it and they make it big. If the economy continues in the doldrums, no sweat, the S&L goes bellyup, but FSLIC antes up a few hundred million dollars, the depositors are all taken care of on schedule. Who loses? So far, the losers have been the S&L's that are playing the game the way it should be played, sticking with residential mortgages, keeping adequate capital, and earning a modest return. Those straight arrow S&L's have been hit with a punishing assessment that is now more than twice the assessment paid by banks. For many of them it means that their modest profits have become losses. For others, their return has been reduced sharply.

But the ultimate loser, although viewed now as the immovable object, will be the American taxpayer. Senators and Treasury under secretaries can vow no taxpayer bailout, but what happens if the billion dollar a month drain on FSLIC continues? What happens is that the Congress must choose whether to hit the industry with another premium increase, maybe a killer, or appropriate the funds necessary to bail out FSLIC. That means billions of dollars.

In my view, it is clear that the Congress and the regulators should take two actions now. It's going to be very, very hard to do. The odds are overwhelmingly against persuading the Congress, the House and Senate, to act, but this is my position. We should do this now, not next year, but now.

We should provide that no insolvent S&L can continue to grow—that is, to buy more deposits. Second, we should provide that henceforth no insurance will be provided for any deposits assumed by a thrift in an S&L that does not conform with the investment guidelines imposed on federally chartered thrifts.

Without these two actions, the bleeding will go on. The future bailout will become bigger and bigger. The present billion dollar monthly loss in the industry will swell to $2 billion, $3 billion and more. It's time to act.

Now today the committee will hear from three former chairmen of the Federal Home Loan Bank Board, Jay Janis, Dick Pratt, and Ed Gray. Yesterday, we heard testimony placing a good share of the blame for the S&L crisis on the regulators. This morning, the regulators will have their day in court.

All three of our witnesses are old friends of this committee. They have testified on numerous occasions, some pleasant and some not so pleasant. They have taken their share of praise and blame and I expect they will take more today. All three are big boys and should be well prepared to answer our questions with candor and directness.

The committee is seeking answers to three questions. What went wrong in the S&L industry? What will it cost? What should be done to prevent it from happening again?

The three former chairmen of the Bank Board are in a unique position to give us the answers to these questions and I look forward, gentlemen, to your testimony.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

Today, we are privileged to hear from three of our past chairmen of the Federal Home Loan Bank Board. Yesterday's witnesses from the thrift industry pointed fingers at just about everybody except themselves in trying to spread the blame for the FSLIC problem. They reserved their special venom for the policies of each of you and you're going to get your chance to respond. How much of the problem was caused by Bank Board policies? What is the situation now? Is the Bank Board regulatory system up to the task of handling the problems before it in both the short term and the long term? These are questions that I hope you will address.

It is also your chance to tell us where you think Congress should go from here both in the long and the short run. I will be particularly interested in hearing your views on the establishment of a bipartisan commission to make recommendations about the problem in the next 6 months.

Commissions come and go and often commissions are simply a copout by administrations or Congress so that we won't have to take action. Instead we recommend a bipartisan commission to make recommendations to us. Most of the time their reports gather dust. There are notable examples, such as the Social Security Commission. So I would appreciate your views on whether you think this is one that might work and might be helpful.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

Gentlemen, you each have 10 minutes and we're looking forward eagerly to your testimony. We're going to go in chronological order of when you served as the chairman. We will start off with Mr. Janis.

STATEMENT OF JAY JANIS, CHAIRMAN OF THE BOARD, GIBRALTER SAVINGS, BEVERLY HILLS, CA

Mr. JANIS. Thank you, Mr. Chairman and members of the committee.

Certainly the first question is: How did FSLIC get into this condition? Unfortunately, a simple answer is not always the right answer.

HOW THE PROBLEM CAME ABOUT

It would be simple and easy to say: Deregulation was a flawed concept, or the way it was carried out was flawed, or there was a failure in examinations and supervision, or it was the oil patch real estate, or it was high interest rates back in 1980 through 1983, or it was the venality of certain new thrift managers and their fraud and mismanagement, and so on and so on.

In my opinion, none of these statements, taken alone, is the cause of the problem. My theory is the "Confluence of Adverse Circumstances." Think of it this way. Not only was deregulation initiated without forward planning and launched backward—liabilities deregulated ahead of assets—but regrettably, a number of adverse circumstances occurred along with deregulation at roughly the same time in the early 1980's.

Who would have thought that we could have had the misfortune to have launched something as fundamentally significant as the deregulation of America's financial institutions at the same time that interest rates rose to unprecedented levels due to the Fed's fight to stem inflation; at the same time that thrift capital was eroded due to the effect of inverted yield curves on mismatched portfolios; at the same time that new asset powers were granted by Congress to federally-chartered thrifts in 1980 and especially in 1982 when their capital was weak; at the same time that California gave virtually unlimited investment powers to State-chartered thrifts and opened the flood gates to new charters—an open invitation to unsavory people to flock into the business,—and a few other States were not far behind California—at the same time that oil prices dropped and Southwest real estate plunged, coupled with gross overbuilding in Texas real estate markets?

The advent of deregulation, coming on the scene at the same time as these other adverse circumstances, and some others I haven't mentioned, caused a critical mass explosion a few years later.

So who are the culprits? Was it a failure of public policy makers? You bet it was.

Was it a failure of the Carter and Reagan administrations to have planned the step-by-step process of deregulation? You bet it was.

Was it a failure of regulators and legislators who gave too much too fast and, more important, failed to consider the impact on the "common insurance fund"? You bet it was.

Was it a failure of examinations and supervision in those days to rein in the fast buck artists and OMB for not giving them the staff to do so? You bet it was.

Was it the failure to have stopped California and other States from opening the flood gates to new powers and new charters, some of which went to crooks? You bet it was.

Was it a failure of some old-time thrift managers to deal wisely with the new powers? You bet it was.

Now if you're looking for a place to pin at least some of the blame, you don't have to look much farther than those in this room today.

Some of the culprits are the three of us at this table, some of those on the dais in front of us, and maybe some in this very audience.

What should we have done differently back then?

First, I think we should have placed less ideological reliance on deregulation and Darwinian theories of the free market.

Second, I think we should have severely limited the States' ability to grant new charters and the growth that came with them.

Third, I think we should have faced up to the States'-righters, refused to insure State-chartered thrifts when the grant of new asset powers was excessive, or at least made the States ante up to cover the added risk, and perhaps most important, fourth, we should have restructured the deposit insurance system to adjust for the anticipated, increased risks involved in deregulation.

That means enhancing the quantity and quality of examiners and supervisors. That means adjusting the insurance premium structure. And that means requiring a higher net worth cushion.

The second general question is: What do we do now about fixing the problem?

POSSIBLE SOLUTION

Two big objectives must be: First, stop the bleeding. It's costing over $7 billion per year at least just to keep insolvent thrifts open. That, of course, takes big dollars. And second, deal with the underwater assets over time. That takes an HOLC/RFC-type asset disposition agency.

Finding the money means looking to all sources before you look for Federal dollars. It means looking to the two insurance funds. It means looking to the Federal Home Loan Bank System funds that have been committed but not used for FICO bonding. It means looking to the interest on sterile reserves at the Fed. It means looking to S&L assessments, as long as you don't cripple the healthy institutions and the policy becomes self-defeating in the process, and so forth.

Now you add all those dollars up and the difference, regrettably and undeniably, has to come from Federal dollars. Anyone who tells you differently, in my opinion, is living in an Alice in Wonderland world.

There is not a whole lot you in the 100th Congress can do, except pave the way for the 101st Congress. Therefore, I'm very pleased to see that Senator Graham and Senator Sasser have introduced legislation, approved by this committee last week, for a congressional commission to study and produce a program that Congress can enact.

I am absolutely convinced this is the best way for you to go. And this has to do with my second theory, which is the "Theory on the confluence of new people," people, who will be realistic about how to go about solving the problem. I am absolutely convinced that this commission and preparing for it is the best use of your time between now and the end of this session. In setting it up, you must give them a mandate beyond recapitalizing. You must require them to think in terms of restructuring of deposit insurance. Otherwise, the problems may reoccur.

Now there are a number of short-term steps that you can take between now and then. I'll be happy to propose about a dozen of them for your consideration during the question period.

One final issue. Should there be a separate thrift business when all of this is over? If you believe in housing and the need for housing finance, as I do, the answer is yes. The need for specialized institutions devoted to mortgage finance is still a valid idea, no matter what some people may tell you.

After all, just about all the major nations of this world—dozens of them—have separate home finance systems, public, quasi-public, or private.

Why is that? And why do we have one? It's because they realize that the individual home buyer/borrower/renter cannot be expected to compete with larger and more powerful entities for the available flow of mortgage credit.

We in this country realize that, too, and we also realize that the promise of a decent affordable home—as shopworn as some say that concept is—just happens to have been an extremely important factor in making American democracy work.

Thank you, Mr. Chairman.

[The complete prepared statement of Mr. Janis follows:]

Testimony of Jay Janis

Before the

Committee on Banking, Housing and Urban Affairs

of the

United States Senate

Washington, D.C.

August 3, 1988

Mr. Chairman and Members of the Committee:

My name is Jay Janis. I am a former Chairman of the Federal Home Loan Bank Board, having served in that capacity in 1979 and 1980 at the time that deregulation of our financial institutions was launched during the Carter Administration. I have held various other positions at the Federal level, including Undersecretary of the Department of Housing and Urban Development (1977-79) and Executive Assistant to the Secretary of HUD during the Johnson Administration. I was President of California Federal Savings in 1981-82, and I am currently Chairman of the Board of Gibraltar Financial Corporation and Gibraltar Savings, a large California thrift association with $15 billion in assets. Also, at the request of the regulators, I chaired the Boards of Centennial Federal Savings and Flagship Federal Savings, two institutions in the Management Consignment Program (MCP). In my earlier years, I was a community developer and home builder in Florida.

I appreciate the opportunity you have given me to present my views to this Committee. I am always pleased to testify before old friends, even if the subject is the difficult problem of the Federal Savings and Loan Insurance Corporation (FSLIC). As I understand it, this is a two-part assignment: First, to discuss how the problem occurred; and, Second, to suggest how to solve it.

As to how the problem occurred, I would like to advance the "Theory of the Confluence of Adverse Circumstances." As to how to solve it, I would like to advance the "Theory of the Confluence of New People." Before explaining these theories, I think it would be useful to say a word about simple answers and to provide some historical perspective on the FSLIC problem.

No Simple Answers

Everyone appreciates a simple answer to a complex question. It would be nice to say that FSLIC's problems came about as the result of A, or B, or C. Some of the easy answers we often hear are the following:

- Deregulation was a flawed concept from the start.
- Deregulation was a proper concept but was poorly carried out.
- Domestic financial markets changed too rapidly for America's out-moded depository institutions to adapt.

- Examinations and supervision failed--in part because regulators were overwhelmed--in part because OMB and Congress would not provide the extra staff that was needed.
- The world-wide crash in oil prices and the resulting depression in "oil patch" real estate markets that followed meant that financial institutions in the southwest could not possibly survive.
- The ultra-high interest rates and volatility in the 1979-1982 period that occurred as the result of Paul Volker's zeal to whip inflation proved to be calamitous for a business which was required by regulation to lend long and borrow short.
- The cupidity and venality of certain thrift executives--especially the high fliers who came into the business recently to take advantage of the new powers--brought the problem on themselves and the entire industry.
- The old-line managers in the thrift business, although skilled at making residential loans, lacked the expertise to cope with rapidly changing world financial markets, a whole host of new financial instruments, and the new powers that were granted.
- The absence of guidelines to deal with the anticipated effects of deregulation was a grave oversight.

Regrettably, none of these statements--taken alone--provides an adequate explanation of what went wrong with the FSLIC, nor for that matter do these statements comprise a complete list of all the possibilities! But they do provide a basis for putting together a theory about the causes of the problem.

What did happen, in my view, is that deregulation of our financial institutions, which began in the late 1970s, happened to take place at the same time that a number of other adverse circumstances occurred. If these other circumstances had existed alone, or without deregulation, they might not have resulted in disaster. Taken together, and combined with deregulation, the result was a critical mass explosion of monumental proportions--hence, my "Theory of the Confluence of Adverse Circumstances." Some call it the thrift crisis of the late 1980s in America. Others, who prefer accuracy, call it the FSLIC crisis.

Some Historical Perspective

A description of the events leading up to deregulation provides a useful perspective from which to view the current problem. Let me begin with a brief review of the modern era of thrifts in America.

The modern thrift era began during the Great Depression with the Congressional enactment of legislation that created a comprehensive scheme of federal regulation of what were then commonly known as building and loan associations. The 1932 Federal Home Loan Bank Act created the Federal Home Loan Bank System as a source of liquidity for member institutions and established the Federal Home Loan Bank Board as the system's federal overseer. In 1933, the Home Owners' Loan act authorized the Bank Board to grant federal savings and loan association charters and to regulate and supervise such associations. In 1934, the Federal Savings and Loan Insurance Corporation was created, as an analog to the Federal Deposit Insurance Corporation, to restore depositor confidence after the wave of building and loan failures that characterized the early depression years. Because the FSLIC was a de facto part of the Bank Board, this gave the latter regulatory responsibility over state-chartered thrifts that elected to have FSLIC insurance.

The fact that Congress created a separate federal regulatory, deposit insurance, and liquidity system for the thrift industry reflected the judgement of Congress that there was a need for a separate set of financial institutions devoted to "economical home finance." Nowadays, critics contend that the thrift industry was founded on a flawed base--long-term mortgages to be financed by short-term deposits--but no one disputes that the system served housing finance well for at least 30 years after its creation.

Then, in the 1960s, deposit interest rate control was extended to the thrift business as a way to keep mortgage rates low by putting a lid on what thrifts could pay depositors. (Rate control had come to banks in the 1930s.) This was an early warning that there were cracks in the system, and soon thereafter, various blue-ribbon commissions and various academicians began to study the problem. In the early 1970s, they put their collective fingers on two emerging problems: a) the danger of disintermediation stemming from a highly regulated depository institution system; and b) the inability of the U.S. financial system to keep pace with growing domestic and international competition. As a result of their findings, they sounded a call for DEREGULATION.

At first, policy-makers weren't listening. But, in the mid-1970s, as Wall Street's newest brainchild, the Money Market Mutual Funds (MMMFs), came onstream and no one saw fit to regulate their deposit gathering, the spectre of disintermediation loomed larger still and thrifts actually began to lose deposits at an alarming rate.

The regulators reacted ever so slowly. At first they granted permission to thrifts to issue longer-term certificates at somewhat higher rates. Later on, in 1978, they approved a short-term, competitively-priced six-month money market certificate. Policy makers felt they had no choice, since they wanted to ensure the continuing flow of mortgage credit into housing.

In the Carter years, the difficulties of perpetuating a tightly regulated set of financial depositories began to be recognized. A task force led by Treasury and HUD, which included all of the appropriate regulatory agencies, called for the initiation of deregulation of the depository system, and, in particular, for permission for institutions to be able to make adjustable rate mortgages (ARMs). The need for deregulation of America's depository institutions--along with certain other industries--soon became the Conventional Wisdom of its day.

The 1980 Depository Institutions Deregulation and Monetary Control Act was the culmination of the effort to deregulate deposits. In that Act, the phased, six-year deregulation of bank and thrift deposit rates was initiated through the good offices of one of the least known, but most colorful institutions Congress ever invented--the Depository Institutions Deregulation Committee or DIDC as it was called. (As a charter member of this Committee, I found myself out-voted by precisely four votes to one on nearly every occasion.*)

There was some small recognition that the deregulation of the asset side of the balance sheet had been neglected in the 1980 Act, and a few new powers were granted. Hurried attempts were made over the next two years to grant new asset powers in three major ways: 1) by Federal legislation; 2) by action of certain state legislatures; and 3) by the 1982 Garn-St Germain Act. Now the stage was set for the "critical mass" explosion--the result of the confluence of adverse circumstances that had taken place over these few short years.

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* This was because I wanted to slow down deregulation on the deposit side, since interest rates were at unprecedented levels and financial markets were gyrating wildly. Apparently, my fellow DIDC members--the Secretary of the Treasury, the Chairman of the Federal Reserve, the Chairman of the FDIC, the Administrator of the Credit Unions, and the Comptroller of the Currency (non-voting)--believed that deregulation, once launched, should be carried out without concern for these events or for the plight of the thrifts, which had been trapped in fixed-rate asset portfolios. In fact, the majority of DIDC members were in such a hurry to carry out deposit deregulation that for all practical purposes they completed the Congressionally- contemplated six-year phaseout a full two years ahead of schedule in 1984.

The Confluence of Circumstances:

Who could have predicted that the unplanned deregulation of the depository institution system would be launched:

at the same time that

- interest rates rose to unprecedented levels and financial markets were enormously volatile;

at the same time that

- thrift profits were squeezed and their capital base was eroded leaving them in a severely weakened condition to face the new competition resulting from deregulation;

at the same time that

- Congress and the regulators realized their error and rushed to give them new asset powers to allow institutions to diversify their portfolios and to correct the "backwards" way in which deregulation had been launched (i.e., liabilities ahead of assets, and, particularly, the fact that institutions had not been permitted to make ARM loans*);

at the same time that

- California--and then some other states--foolishly decided to give virtually unlimited powers to their state-chartered thrifts;

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* Beginning with FHLBB Chairman Tom Bomar in the mid-1970s, regulators told Congress that ARM lending was necessary, but Congress objected. During my tenure at the Bank Board, we finally authorized the Renegotiable Rate Mortgage (RRM) in 1980, based on the so-called Canadian rollover mortgage. I was personally excoriated for this action in especially bitter hearings before a House consumer affairs panel and also in the New York Times where I was referred to as "the Rasputin of the consumer movement." (And this was despite the fact that the RRM contained more consumer safeguards than the ARM, which came later.)

at the same time that

- California and other states adopted a liberal chartering policy which opened the floodgates for the entry of individuals of dubious character, many of whom eventually engaged in fraudulent behavior;

at the same time that

- the OPEC cartel broke up, paving the way for a glut in world oil supplies, a plunge in world oil prices, unemployment and depression in the southwest, and a severe drop in real estate prices. (On a regional basis, the real estate devaluation and loss experience in some Texas cities was more severe than the Great Depression);

at the same time that

- old-line thrifts--already in a weakened capital position and searching desperately for higher earnings--were given new powers and new investment opportunities without adequate experience to handle them;

at the same time that

- the regulators of the thrift business--though struggling mightily to keep the system alive in the hopes of better days ahead--were understaffed, underpaid, undertrained, and just plain overwhelmed. In part, this was because lawmakers and the Office of Management and Budget failed to recognize the implicit dangers inherent in deregulation and because the pleas of regulators for more funds and more staff fell on deaf ears.*

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* As early as 1978, my predecessor, Robert McKinney, sounded the alarm before the House Appropriations Committee and was rebuffed in his request for additional examiners. His request was very specific: "... additional staff is imperative... if... OES is to continue to meet the workload requirements imposed by new legislation and activities, adequately examine the operations of the insured institutions and their service corporation affiliates, reduce the examination cycle to a more prudent level, perform the requisite special examinations in those instances where the insured institution is not responsive to supervisory efforts, and more closely monitor and analyze industry financial and operating data between examinations to identify developing problems at an earlier date..." (Source: Federal Home Loan Bank Board Justification for 1979 Estimates, Prepared for The Committee on Appropriations, House of Representatives, 1978.)

So Whose Fault Was It?

Given the occurrence of this unfortunate confluence of adverse circumstances over a relatively short period of time, is it really any wonder that the thrift insurance fund is where it is today?

- Was it a failure of public policy making? You bet it was.
- Was it a failure of the Carter/Reagan Administrations to plan, step-by-step, the process that deregulation would take? You bet it was.
- Was it the failure of regulators and legislators who gave too much, too fast? You bet it was.
- Was it a failure of examinations and supervision to rein in the fast-buck artists and the failure of OMB to give them additional staff to do so? You bet it was.
- Was it a failure not to have stopped California and certain other states from opening the floodgates in terms of new powers and new charters because of the fear of offending the "States' Righters?" You bet it was.
- Was it the failure of some of the old-line thrift managers to deal wisely with the new powers? You bet it was.

This Raises the Multi-Billion Dollar Question: "Who Pays the Bill?"

Obviously, there is a shared responsibility here. One could debate endlessly as to precisely how to sort out the liability and where to pin the blame. But I'm not sure it matters a whole lot because no matter what amount is assessed to the thrift industry for its share of the blame, it is not sensible to extract more from the healthy part of the business than it can afford.* Otherwise, in the process of "fixing the problem," the two thirds or more of the business that is now healthy will be destroyed. That would certainly be self-defeating and poor public policy.

So far, the thrift business alone has been paying the bill. If attempts are made to bleed them to death as the tab mounts, they will not remain as viable entities and the industry will not survive. (The Bank Board has projected that the cost of the insurance premiums levied on thrifts, if the special assessment is continued through 1998, will total more in dollars than their collective GAAP capital as of March 31,

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* Besides, the well-managed thrifts can legitimately argue that they are victims, not perpetrators; and therefore any extraction from them should be minimal.

1988.) In fact, if thrifts are pushed to the wall by heavy assessments in the future-- assessments that cut their earnings by, say, 10% or 20% or 50% or more, and thus severely erode their capital--they may follow the natural economic law of trying to earn back the lost money and take risky chances, which again would be self-defeating for themselves and for any government insurance fund. (What we run up against here is the "law of diminishing returns," and, like the law of gravity, no one has found a way to repeal it.)

Now, this question of who pays--and the equity or fairness inherent in the question--is at the heart of the second part of this assignment: that is, to answer the question: "How do we solve the problem?".

Where Do We Go From Here?

Unfortunately, most of the policy makers currently on the job have adopted positions which make it very difficult for solutions to be found. For instance, many of them have been saying:

- No Federal funds should be expended;
- Enough cash flow is available to handle daily needs from assessments, investment income from the portfolio, issuance of FSLIC notes, and recovery from receivership assets; and
- Capital is adequate over time from these same sources to cover future needs. (By now, it should be obvious to all that, although a range may be estimated, no one knows the real size of the problem with any certainty. This should come as no surprise given our volatile economy and our dynamic real estate cycles.)

For a solution to be found, there must be a change in the players--a change that in fact will occur in 1989 regardless of who is elected President. (This is my "Theory of the Confluence of New People.") Then, a new stage will be set and important new actors who we hope are realistic will be on that stage:

- There will be a new 101st Congress;
- There will be a new administration in the White House, Republican or Democratic;
- There will likely be a new Treasury Department official who will head up policy-making for banks and thrifts;
- There will be a new chairman of the Senate Banking Committee (and I will dearly miss the retiring one);

- There may or may not be a new chairman of the House Banking Committee, depending on the vagaries of the election process;
- There will likely be some new regulators heading up the relevant banking and thrift agencies.

My "Theory of the Confluence of New People" is not meant as a negative statement about the capacity of the incumbents. Rather, it is a statement about the positions to which they have become wedded in an election year and the need for new people, with fresh viewpoints, to get the process unstuck. Given these new players, the question is, "How do they fashion a solution?"

A Blue-Ribbon Commission

I urge Congress to create a Special Blue Ribbon Commission to consider the restructuring of the depository institution system in America. I must emphasize that I am talking both about the FSLIC and the FDIC because it strikes me that the FDIC and their commercial banks are not in the clear on any of this either. I refer, in particular, to the problems of commercial bank lending in the "oil patch" and the unrecognized losses from LDC loans made by the larger banks that have not been universally recognized as yet by policy makers. I also hasten to point out that I am talking about the restructuring of the depository institution system in America, not the recapitalization of the insurance funds. A recapitalization or bailout of the insurance funds is merely a half measure. A restructuring of the depository institution system is a far broader charge. It is not a bailout, and it is precisely what is required, especially if one looks at the last 50 years of banking history in America, at the structural flaws in the creation of the thrift side of that business, and at the landmark deregulation that changed the world for depository institutions in America once and for all. To think of just recapitalization, instead of restructuring, would be the height of myopic policy-making.

I note with satisfaction that different bills have already been introduced in Congress to form such a Commission. My sense is that the Commission should number approximately 15 to 20 people consisting of:

- Senators and Congressmen from both parties
- Appointees from the new Administration
- Outside experts selected by Congress and the new Administration
- Executives from the thrift and banking business
- Regulators as non-voting advisors

The Commission should be given:

- An independent staff (not Capitol Hill staff; they're too busy for full-time duty);
- Appropriations to pay for staff, travel, and minimum consulting and legislative drafting; and
- A 90-day mandate right after the first of the year (but with no public hearings) to produce a package that is ready to be put into statutory format immediately.

The Next Steps in the Process

Once the 90 days are up, the process is simple: The Commission would report its findings in the spring of 1989. Congressional hearings would begin, having been scheduled well in advance (with lawmakers' calendars cleared months before) for May and June. This would be followed by passage of the new legislation in both houses, followed by a conference in July, and then enactment by the magic date of August 10, 1989, the date of the expiration of the extended moratorium--a deadline Congress has imposed on itself. The schedule is tight, but I think it can be done.

It would be premature for me to make a judgement about what should be in the package itself. But I think I can suggest what some of the elements of the package might be that the Commission should study. Here are some of them:

Some Issues to Be Considered:

- a consideration of how much and how long a special assessment on the healthy part of the industry can be endured, without reaching the "point of diminishing returns"
- the amount of capital available in the FHLB system not previously used but committed for FICO bonding
- the incremental value in the appreciation of FHLMC stock when it is permitted to be sold beyond the thrift business
- the impact of tapping Federal Reserve Board funds from the interest that could be paid on sterile reserves
- the creation of a "HOLC/RFC" agency of a truly federal character (not the Federal Asset Disposition Association) for the holding and orderly disposition of troubled assets
- the dollars that are currently available in both the FDIC and the FSLIC funds and their short-term anticipated cash flows
- the true value of assets in various receiverships and the liklihood of their short-term availability
- the possible inclusion of QTL-qualified commercial banks as members of the FHLB system

- the granting of variable premium authority based on factors such as liquidity, capital reserves, balance sheet riskiness, and current investment activities
- the steps necessary to bring additional capital into the business, including, among others, more efficient administrative processing of proposals, interstate branching rights, and charter powers
- the possibility of finding ways to equalize the advantage that mutual funds and, particularly, government secondary market agencies enjoy in providing credit at much lower cost than thrifts
- the ultimate cost of returning to the days before the 1986 Tax Reform Act, which converted thrifts from being low margin to high margin taxpayers
- the feasibility of granting favorable tax treatment for distressed real estate owned by depository institutions

and, of course, most important

- the amount of federal funds to make up the difference between all of the above and what's needed, and how these federal funds should be employed to minimize the impact on the budget

A Structure for the Commission's Work

No doubt the Commission will want to place all of these and other issues under three or more topical headings. One heading is sure to be "The Source of Money to Solve the FSLIC Problem." This will require totaling all of the potential sources of funds which can reasonably and fairly be used, and adding to that sum the amount of federal dollars necessary to deal with the problem.

A second heading will likely be "The Use of the Money." Under this heading, the Commission will have to consider such thorny issues as how much of the money to expend up front and how much to spend over time, and what mechanisms to use to reduce the impact on the federal deficit.

A third probable heading is "The Structure of the New Depository System." This will require finding answers to such key questions as: Should there be two separate insurance funds? Should there be two separate sets of regulators? Should there be two separate systems for state and federal charters? Should deposit insurance premiums be structured differently than they are now?

Certainly a fourth heading will be "Steps to Insure that the FSLIC Problem Will Not Reoccur." In this case, among other considerations, the Commission will need to explore whether the dramatic improvement over the past few years in the quality and quantity of examiners and supervisors provides adequate protection for the new federal dollars.

Although there may not be a specific heading to cover it, the Commission will surely discuss whether a separate and distinct thrift business should be perpetuated into the future. The very question is a reflection of current Congressional frustration: The size of the problem has been underestimated nearly from the beginning; Congress has concluded it was misled as to the ease with which it could be handled; and as the statistics got worse and the sensational news stories proliferated, Congress slowly has come to the determination that it might be dealing with a problem which would not yield to a simple resolution and which was far more vexing than anyone originally had contemplated. Compounding the frustration is the fact that the effects of deregulation in other similarly deregulated industries--trucking, railroads, airlines, stock brokerage, and telecommunications--were more easily understood and predictable.

Frustrations aside, my opinion is that the Commission will conclude that America continues to need a thrift business. Housing depends on it, and democracy depends on our citizens' potential to realize "The American Dream." This is another way of saying that there is an unwritten compact between our government and its people for decent, affordable housing for everyone.

Dozens of other nations have come to a similar conclusion about the need for a specialized system of housing finance-- private, public, or quasi-public to insure that housing is made available to its citizens.* For instance:

- Great Britian has its Building Societies
- Germany has its Bausparkassen, Mortgage Banks and Savings Banks
- Canada has its Trust Companies
- France has its Credit Foncier
- Italy has its Mortgage Credit Banks
- Spain has its Banco Hipotecario de Espana and Confederated Savings Banks

The Commission will have to acknowledge that these nations, and America since the 1930s, have recognized the impossibility of subjecting the individual home buyer/

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* For a complete list, see: Boleat, Mark; National Housing Finance Systems: A Comparative Study. London: The International Union of Building Societies and Savings Associations, 1985.

borrower to competition from other, larger and more powerful entities for the available flow of credit dollars. Just as in the United States, these nations had to create a separate system of savings institutions devoted solely to mortgage finance.

Conclusion

Between now and the time the Commission goes to work, it is vital that this Congress ensure that nothing is done to preempt the next Congress' ability to put this type of package together. I have in mind the possible over-obligation of the FSLIC by its issuance of FSLIC notes and the threat of draining off the capital of the FHLB system by the non-payment of those notes. At the very least, legislation could make clear that the FSLIC notes would not be abrogated in the event of the merger or liquidation of the funds.

I believe that the 100th Congress has the opportunity to set the stage for the 101st Congress, and I commend you for these hearings. I hope from these deliberations that the necessary steps can be taken to ensure that a Commission goes to work in January, 1989 with a proper charge as to what its mission will be. With all due respect, I believe that making sure this happens is the highest and best use of your time between now and than. And I must tell you that I remain optimistic about this nation's ability to solve these problems and to position both our thrifts and our commercial banks to compete in a world of deregulated banking, commerce, and "economical home finance."

The **Chairman**. Thank you very much, Chairman Janis. Chairman Pratt.

STATEMENT OF RICHARD T. PRATT, CHAIRMAN, MERRILL LYNCH MORTGAGE CAPITAL, INC., NEW YORK, NY

Mr. **Pratt**. Thank you, Mr. Chairman. I may reserve my right for a separate trial based on Mr. Janis' confession, but will proceed.

One, I'd like to thank you for the opportunity to appear here and I assume this will probably be the last time I have the opportunity of speaking before you and express my appreciation for the leadership and the kindness with which you treated me when I was here before.

I think that it's very appropriate obviously to be looking at this subject today and it is a major problem. I think the problems are both simple and complex and I'd like to take just a moment and set the framework which I think underpins the situation today. That is, that we have local financial markets in which individuals operated in a protected sense with the moral guarantee from the Government that the insurance corporation was not really an insurance company at that time.

The reason we have Federal deposit insurance in this country, in my opinion, goes back to the issues between Andrew Jackson and Nichols Biddle, and I'll save those for another hearing. But in other countries where we have central banks and branch banks, essentially financial regulation and safety occurs through moral suasion. Here we have unit banks. We have a proliferation of banks. And there had to be some moral umbrella. The moral umbrella was deposit insurance but the structure was originally set in such a fashion that the FDIC and the FSLIC were not expected to operate like a life insurance company or a casualty company with an expected number of claims, but they were mainly protected by the monopolistic and oligopolistic powers which they were given. They were given very protected positions within their community. It was very hard for outsiders to come in and compete with them. We didn't have the mass media. We didn't have computers. We didn't have low-cost communications. These were truly to a large extent local financial institutions bringing in local dollars, lending them on a local basis, and giving the consumer the advantage of a low-cost banking system through the deposit insurance mechanism.

TECHNOLOGICAL CHANGES IN COMMUNICATION

Unfortunately, while this system worked very well for the period of isolation and so on when it was incorporated, technology was changing around the financial system and this cannot be underestimated. What the effect of the change in communication, the change in being able to access the United States as an entire market at one time and this reached from the smallest town in Utah to the city of New York. It was a national marketplace and many of our concepts of local and separate and protected competition became unworkable.

There was originally a reaction against this type of thing with the imposition of regulation Q which controlled interest rates and we thought we had solved the situation at least at that time.

What this caused was great volatility in the access to money. The cost of money at thrift institutions didn't change rapidly, but the access to money changed and we invented a new word called disintermediation.

Deregulation is something which I think had to come and which I think is beneficial and I don't think anyone needs to apologize for deregulation. Clearly, there have been errors made. Clearly, there are substantial losses. This is a big system and I don't think that any single factor is the cause of it.

I'd like to spend just a moment to speak about the time that I was at the Bank Board. In 1981, the savings and loan industry was in its greatest crisis to that time and the losses being experienced by the industry were substantially greater than they are today. In 1981, the thrift industry was losing at a rate of 70 basis points per year on total assets. In 1982, it was losing 60 basis points. Some of the gentlemen sitting in this room that represent the best managed and biggest and finest institutions in this country were within 24 months of insolvency. This was a universal panic among the managers and operators of these institutions and we maintained a computer run at the Bank Board that showed this whole industry going over the edge. It could not survive under those conditions.

We felt that a proactive leadership program in conjunction with Congress, while it wouldn't solve the interest rate problems, would provide a basis for the continuation of this industry. For years it had been denied the ability to make adjustable rate mortgages. We did that within 60 days of the time that we got to the Bank Board. We worked with the chairman of this committee, at that time Senator Garn, and the ranking minority member, at that time Senator Proxmire, in developing legislation which I think was very enlightened. Nobody needs to apologize for the Garn-St Germain bill. It was a good bill. It made thrift institutions better. It was good for the consumer and it was not an overreaction.

It is clear that some of the interface between the State and Federal regulation needs adjustment and probably should have been addressed at that time. There's no question that historically the Federal regulations which control risk should have been FSLIC regulations rather than Bank Board regulations. That would have eliminated some of the issues of which we speak.

Let me just talk to the cost for just a moment. I've heard everyone's estimates. I don't think anyone knows. My personal estimate is that it probably is in the $50 to $75 billion range today and I believe that that cost was caused, as Mr. Janis does, by a combination of factors, the dearth of real capital from the interest rate risk of the 1970's and a poor accounting system that I will speak to later, and the regional depressions of the 1980's. These things came together to cause this cost. I think the Bank Board probably has the best ability to estimate it, but in looking at the numbers I see operating costs, without regard to losses on assets, of about $6 billion per year. If you capitalize those, you're looking in the $60 billion range. When I adjust the net worth figures that I see for what I think are the adjustments, again it comes up somewhere in the $50 billion range. I believe it will be in the $50 to $75 billion range.

FINANCING THE COST

I would like to say that there are several approaches to financing that. One is to have the industry pay for it. As I see it, it would take an insurance premium 72 basis points on the healthy thrifts. I think that's impossible. I think the issue of merging the FSLIC and the FDIC is obviously worth consideration and charging the standard premium, however enlightened that may be, that may pose more of a problem for you as elected representatives than it does for us as economic observers. And third, I believe there probably will be a shortfall and whatever is said, the obligations to the depositors are real. Those obligations have to be paid and there's only one way they can be paid ultimately and that's with a check. And we shouldn't be too innovative in trying to find ways to continually string the problem out rather than pay some of those problems.

I have a number of suggestions that I think might be helpful. At the time that I left the Federal Home Loan Bank Board, my agenda had I remained and the speeches that I gave at that time focused on four areas. They were: (1) the requirement of more real capital in thrift institutions; (2) the possibility of variable insurance premiums or variable capital levels based on risk within insured institutions, and at the time we left we had a proposed regulation out on variable premium insurance; (3) better accounting. The relationship between generally accepted accounting principles and good financial disclosure for thrift institutions is like the relationship between military music and music—there is none. We are operating in the dark as far as having good financial information on these institutions.

Finally, the holding of management and boards responsible for their acts.

I still think those are good suggestions. There are some operating things that I think could be addressed. I mentioned the accounting system. All risk-bearing should be under the purview of the FSLIC. State regulation which causes Federal costs is anachronistic. Insurance cost is based on deposits where the risk to FSLIC is caused by what institutions invest in. That needs to be addressed. Using FSLIC funds to support secured borrowings by thrifts increases risk to the FSLIC and government supported growth options for troubled thrifts having negative capital are counterproductive. They may solve one problem, but they cause many others.

I will, of course, answer any other questions that might occur, but we've got to get the insurance business out of the operating insurance business. It's got to be returned to being a moral guarantee of these financial obligations.

[The complete prepared statement of Mr. Pratt follows:]

TESTIMONY OF

RICHARD T. PRATT

BEFORE THE

UNITED STATES SENATE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

August 3, 1988

Thank you Mr. Chairman, for the opportunity to address with this Committee the factors that have had a bearing on the operations and financial health of the thrift industry and the regulatory actions that have been taken in response. In that respect, with your approval, I would like to submit my full statement for the record. I would also like to acknowledge the assistance of Thomas P. Vartanian who collaborated with me in the drafting of this statement.

HISTORY AND BACKGROUND OF THE THRIFT PROBLEMS

The modern thrift industry was born with the enactment of three major pieces of legislation:

The Federal Home Loan Bank Act of 1932

The Home Owner Loan Act of 1933

The National Housing Act of 1934

These pieces of legislation set the framework for a system of federally and state chartered institutions whose deposits were effectively insured by the federal government and which were regulated by state and federal authorities. The system generally worked well for an inordinately long period of time. From the mid 1930s until the late 1970's. The success was based on the structural environment in which the institutions were operating. This period was characterized by relatively local markets, strong monopolistic, or oligopolistic positions by insured thrift institutions, and a lack of ready substitutes for insured deposits on the part of the consumer.

The first destabilization of the system appeared in the 1965-1966 era when increasing interest rates caused a fear of disintermediation from local financial institutions into major money center banks. Regulatory authorities responded by imposing broadly based interest rate limitations on depository institutions in the form of Regulation Q. Because of the historic precedence of thrifts paying higher rates than commercial banks, thrifts were granted a one-half of one percent advantage in the rates which could be paid on deposits. The imposition of Regulation Q seemed to temporarily solve the problems of depository institutions, but regulatory and Congressional authorities failed to fully appreciate the changing market conditions.

While the regulatory and legislative structure remained basically unchanged, the market place was changing at an ever increasing rate. Three factors were important in setting the stage for the later difficulties experienced by depository institutions: (1) the development of computers for financial institutions, (2) lower communications costs, and (3) the development of mass markets that became accessible through broadly distributed media channels.

The changing technology allowed for the development of close substitutes for the insured deposit. Money funds were put together which had invested in highly liquid riskless investments at market rates. These money funds sold shares which were clear substitutes for depository institutions' insured deposits and which were not subject to rate control. Communication and mass market development allowed outside competitors to enter previously protected local markets.

By the mid-1970s, financial institutions while experiencing relative stability in the cost of their funds, were subject to increasing volatility in the amounts of deposits available to them. Periods of rising interest rates caused the diversion of funds away from thrift institutions and commercial banks into the recently developed substitute instruments or directly into obligations of the United States Treasury or Agency securities.

Insured financial institutions in general were ill-equipped to deal with this changing marketplace. Previously because of the limited entry of insured institutions, and the relative isolation of individual marketplaces, financial institutions were able to earn relatively consistent profits with small probabilities of loss. Funds could be attained at prices which allowed profitable local investment and intermediation. Management of financial institutions tended to be process-oriented rather than innovative and technologically competent. Institutions were able to invest in relatively illiquid assets of long maturities, knowing that the movement in costs of their liabilities would be glacial, and that they were insulated from the competitive influences of outside operators.

The stage was set for immense operating problems if and when interest rate ceilings were removed. Supervision of financial institutions during this period of time was accomplished generally through moral suasion. Financial institution charters were of great value, because of the attractive monopoly rights to raise funds having the backing of the United States government at controlled costs.

The most sweeping deregulation and that for which the depository institutions proved to be least prepared was the deregulation of interest rates which occurred in the 1980 Depository Institutions Deregulation and Monetary Control Act. This legislation contained provisions which phased out deposit rate ceilings, authorized interest-bearing checking accounts for individuals and broadened the investment authority of thrift institutions into the areas of commercial loans, commercial paper, and corporate debt.

During the crucial period of deregulation and in fact continuing into the present time regulators, the public and management have operated on grossly inadequate financial information. Historical cost accounting allows financial institutions to carry long term assets at amortized original cost, providing little or no insight into the actual financial condition of the institution. From the late 1970s, into 1982, fully guaranteed government national mortgage association securities went from a market price of approximately par to a price level in the mid-fifties. An institution holding these securities or other long term governments or mortgage securities experienced an actual economic loss of forty five percent of assets. While this immense economic erosion was occurring, there was no reporting of it under generally accepted accounting principles. Mortgages, government securities, and other long term assets of investment grade continued to be carried at original cost, even though their ability to generate income fell far short of the economic rents necessary to maintain deposits in thrift institutions and commercial banks. Thrift institutions were especially hard hit by this development, having a greater proportion of their assets in long-term maturities, and having little or no liabilities in an interest insensitive form, such as checking accounts. By 1982, the real capital positions of all thrift institutions had been completely eroded, and virtually all thrift institutions had large negative net worths when their assets and liabilities were valued at actual market rates.

By 1981, regulators and Congress were faced with a thrift industry which had negative real capital, was experiencing operating losses at an alarming rate, and which was substantially antiquated, both in its authorities, and management preparedness to deal with a new environment. No one at the time fully appreciated or foresaw the implications of essentially insolvent financial institutions having the right to issue unlimited amounts of debt in the name of the United States government. Federal regulators undertook an effort to modernize the thrift institution charter to make thrifts better able to compete and provide a basis for viability in the future. The linchpin of this reformation was the Garn-St Germain Act of 1982. This legislation which provided substantial modernization of the charter, and increased opportunity for managerial flexibility along with modest deregulation of assets, engendered a striking response from state regulators.

State regulators having responsibility for state chartered thrift institutions, found that these institutions were relatively disadvantaged in comparison with the modernized federal charter. As a result of legitimate request from state chartered institutions, and a need to maintain state-chartered institutions to support examination and oversight activities, state regulators went into a massive mode of state deregulation, especially in the states of California, Texas, and Florida. Institutions were given relatively carte-blanche authority in terms of the deployment of their assets. An explosive and untenable situation had been created with the federal government being responsible for losses engendered in these associations while having limited discretion in terms of controlling risk-taking on the part of state-chartered institutions. State regulators, having no financial consequences of their own deregulation, removed many traditional constraints on the deployment of assets within state-chartered institutions.

The combination of unlimited access to funds, broad powers for state chartered institutions, the dearth of real capital, and regional depression led to the asset problems of the mid and late 1980s. The Pratt administration took place during the crisis period of early 1981 to early 1983.

The Pratt Administration

I was appointed Chairman of the Federal Home Loan Bank Board, the operating head of the Federal Savings and Loan Insurance Corporation ("FSLIC"), by President Reagan and confirmed by the Senate in April 1981

The Pratt administration of the Federal Home Loan Bank Board, included the late Board member Andrew DePriete, Board member Jaime Jackson and Chairman Richard T. Pratt. The Bank Board was supported by an outstanding senior staff consisting of John S. Buchanan, Chief of Staff, Thomas P. Vartanian, General Counsel, D. James Croft, Head of Examination and Supervision and Charlotte Chamberlain, Chief Economist, Malcom Draper, Assistant to the Chairman, Stephen P. Terry, director of District Banks, and H. Brent Beesley, Director of the Federal Savings and Loan Insurance Corporation.

In 1981, the savings and loan industry was in a life threatening crisis. The cumulative effects of past economic accounting and regulatory circumstances placed the industry in a situation where even the strongest thrift institutions faced extinction. In 1981, all FSLIC insured thrift institutions experienced losses approximately equal to 70 basis points on their assets. During 1982, the rate of losses was occurring at approximately 60 basis points. This was an unprecedented cataclysm within the thrift industry and regulators and Congress had no previous experience with problems of this magnitude and severity. In monitoring the condition of the thrift industry, the Bank Board was aware that even the largest, most well capitalized, and best operated thrifts, were within 2 years of insolvency if the present circumstances were to continue. The Bank Board believed that under these circumstances a strong proactive program to modernize the industry to assist it in dealing with its then present problems and to provide a basis for future viability was imperative.

At the very outset, the Bank Board identified a comprehensive strategy that focused on five central themes:

1. Modernization of interest rate risk management tools to allow institutions to improve asset yields and their ability to respond to market factors more rapidly;

2. Buying time for the economy to improve and for institutions to restructure their balance sheets;

3. Enhancement of the thrift charter through the authorization of new powers to attract capital investment whether by mutual to stock conversion, acquisition or other forms of investment;

4. Resolution of problem cases on the least cost and most orderly basis; and

5. Restructuring of the deposit insurance system to reflect the dynamics of deregulation and market risk.

I. Modernization of Interest Rate Risk Management Tools.

When I was appointed Chairman in 1981, federal savings and loan associations had not yet been authorized to make variable rate mortgages. They were, at that time unfortunately, locked into duration and interest rate mismatching, almost by regulation. Without pointing fingers, suffice it to say that there is enough blame to be shared by Congress, the regulators and the industry for that fact. Thus, although the savings industry's liability (deposit gathering) side had been largely deregulated and, correspondingly, its cost of funds raised, its asset (lending) side was still restricted to fixed-rate, lower yielding mortgage investments. That was a formula for disaster and one requiring the promptest response by our Bank Board.

Within the first 30 days, our Bank Board began responding by publishing proposed regulations which were subsequently adopted into final form with unprecedented speed. A complete list of all those regulations is attached to my statement, which will be submitted for the record. The Bank Board's first adjustable rate mortgage regulation was adopted in final form by the Bank Board on April 23, 1981. The modern-day era of adjustable rate mortgage financing had begun.

This historic regulation was followed by new regulatory statements in 1981 and 1982 providing, for the first time, new investment authorities and interest rate risk management tools regarding among other things, (1) futures transactions, (2) graduated payment adjustable rate mortgages, (3) balloon payment and reverse annuity mortgage loans, (4) financial options trading and (4) the formal validation of mortgage due on sale clauses.

II. Buying Time for the Economy to Improve

The Bank Board in 1981 decided that it was important to soften the financial shock on thrift institutions of the diverse, unfriendly characteristics of the economy at that time. This would permit the better institutions the time to make the appropriate changes in course and adapt to the new financial environment. So, for example, the Bank Board, by regulations (1) broadened the securities that could count as regulatory net worth, (2) allowed the long term amortization of certain discounts and matched losses from the sales of assets, and (3) permitted the realization of the appraised market values on real estate held in portfolio in excess of the historical cost book value.

III. Enhancement of the Thrift Charter

From the first day of my tenure as Chairman, it was apparent that it would be important to maintain and improve the relative value of the thrift charter vis-a-vis the range of competitive charters available to potential acquirors of and investors in regulated financial depositories. The culmination of this effort on the Bank Board's part was the enactment into law on October 15, 1982, of the Garn-St Germain Depository Institutions Act of 1982, and its implementing regulations.

The Bank Board's implementing regulations issued over the following 120 days included new demand deposit and consumer, commercial and real estate lending authorities. Also provided by these new regulations were leasing, corporate debt and commercial paper investment authorities meant to provide institutions with a broader array of asset yield and risk diversification capabilities.

Similarly, we viewed the infusion of new capital into the thrift industry as a pre-eminent goal to complement and document the value of the thrift charter. In that respect, our Bank Board overhauled the mutual to stock conversion regulations to simplify and streamline the normal publicly underwritten conversion, and to expand the conversion process to include supervisory and modified supervisory alternatives, including holding company conversions. In that respect, recognizing the shift from mutuality to stock form throughout the thrift industry, the Bank Board in 1982, allowed for the very first time, mutual institutions to be acquired by stock savings institutions in the now standardized merger conversion process.

IV. Resolution of Problem Cases on a Cost Effective Basis

In 1981, the average present value cost to the FSLIC of resolving problem cases was only slightly less than the estimated cost of liquidation of such failing institutions. A reason for the high ratio of supervisory acquisition costs to liquidation costs was the absence of effective problem resolution case alternatives, both in terms of the variety of structures and the number of acquirors that the Bank Board had been accustomed to use. Accordingly, we determined that FSLIC costs could be reduced if the FSLIC's tools were geometrically expanded. Our Bank Board, therefore, took the following actions:

1. Supervisory cases were prioritized, organized and marketed on an interstate basis, dramatically increasing the number of healthy thrifts that could bid for every failing institution;

2. Commercial and industrial companies were actively solicited to join the bidding process;

3. Commercial banks were, for the first time, invited and encouraged to acquire failing thrift institutions; and

4. The range of alternative structures for supervisory acquisition were expanded to include mechanisms other than the typical purchase and

assumption transaction.

As a result, the FSLIC began to resolve an unprecedented number of failing institution cases while reducing the attendant cost from approximately 75% of the cost of liquidation to approximately 25%.

V. Restructuring of the Deposit Insurance System

It was clear to me in 1981 that the deregulation of the thrift industry which was inevitable and that would be necessary to keep the industry competitive, was on a collision course with the flat rate premium deposit insurance system that is still in existence today. In that respect, we realized that the deposit insurance system would have to be restructured so as to recognize the diversity and degree of risk that institutions would assume. The Congress addressed this issue and commissioned a study of the deposit insurance system by the FSLIC and the FDIC in Title VII of the Garn-St Germain Depository Institutions Act of 1982. Our Bank Board tried to further this effort and begin to implement the findings of those studies by proposing, in early 1983, a variable rate FSLIC insurance premium system that would begin to correlate institutions' capital strength and their interest rate, credit and management risk with the amount of premiums that they would have to pay for their deposit insurance. This proposed regulation was abandoned by the Bank Board after I left the agency.

In the four years that followed my tenure as Chairman, the Bank Board shifted its supervisory focus credit quality, as opposed to interest rate risk, began to become the preeminent problem in the industry. Thus, the Bank Board adopted more restrictive regulations regarding (1) the use of brokered deposits; (2) liability growth; (3) investments in real estate, equity securities and service corporations, and (4) required net worth. In that respect, one regulatory challenge the Bank Board had and still does, is the implementation of these new regulatory limitations in a manner that will control the risk and potential losses to the FSLIC from these activities without unnecessarily restricting the abilities of good managers in the industry to succeed. In other words, the temptation to engage in least common denominator regulation in a deregulated environment creates a continuing tension that requires a sensitive balancing so as not to extinguish legitimate and beneficial entrepreneurial instincts in the thrift industry.

The Scope of the Problem, 1988

The thrift problem of 1988 has at least three major components:

1. The present financial problems stemming from past operations.
2. The present competitive problems of the thrifts.
3. Problems in the present structure and regulation of the industry.

While the present financial problems must be solved a failure to address the competitive and structural problems will result in a condition of chronic financial debilitation punctuated by recurring crises.

The Scope of the Financial Problem

The thrift industry suffers from both chronic and acute financial problems. To a large extent the acute problems are associated with a deterioration of asset quality. In turn asset problems can further be traced to states having either or both inadequate addressing of financial risk or a depressed economy. The accompanying exhibit provides information for the first quarter ending March 31, 1988 for both solvent and insolvent thrifts. Solvent thrifts held approximately $1.13 trilllion of assets while insolvent thrifts held $181 billion of assets. It is clear that as a group GAAP insolvent thrifts can never return to profitability from their own operations. The average insolvent thrift has only $.7610 of interest earning assets per $1.00 of liabilities. Assuming a cost of liabilities of 8% the average insolvent thrift would need a spread on its assets of 251 basis points simply to compensate for non-performing assets. While the net interest margin of GAAP solvent thrifts fell slightly short of the amount necessary to cover operating expenses GAAP insolvent thrifts fell 221 basis points short of the net interest margin necessary to cover operating expenses.

No one knows the amount of funds that will be necessary to solve the present financial problems. Probably the Bank Board is in the best position to make such estimates. The cost of solving present problems also depends on the course of the national economy, as well as the regional economy involved. Nevertheless some approaches to estimating the problem can be pursued.

The negative tangible net worth of insolvent thrifts was minus $22.7 billion at the end of 1987. This number might be taken as an absolute minimum amount necessary to solve present problems. I believe this number is too low for two reasons. First I do not believe that failures will be limited to presently insolvent thrifts. For example the average GAAP solvent Texas thrift has interest earning assets equal to 85% of its liabilities. It is unlikely that sufficient spreads are available to cover this shortfall. A second reason that I believe this number to underestimate the problem is that there are costs associated with problem resolution which are over and above the shortfall in tangible net worth. As a guesstimate I would add another 50% to the negative tangible net worth for problem thrifts that are GAAP solvent and perhaps another $10 billion to reflect the understatement of costs incorporated in negative tangible net worth. The sum of these figures is $44.01 billion. The level of negative income can also be used to attempt to estimate the cost of resolving the problem. The negative adjusted net income for insolvent thrifts in 1987 was negative $10.26 billion. Abstracting from taxes and other adjustments it would require an additional $102.6 billion of assets earning 10% to restore these institutions to a break even status. If one looks only at the operating income of institutions and assumes that nonoperating losses will be greatly limited in the future the negative income is $4.50 billion. However operating losses of insolvent institutions have been increasing and in the 1st quarter of 1988 amounted to $1.56 billion, annualizing by multiplying by 4, provides an implied annual operating loss of $6.24 billion. It would require $62.4 billion of additional assets at 10% to provide sufficient earnings to offset these losses.

Many approaches can be taken to estimate the size of the problem and reasonable estimates will change over time. I believe the shortfall to be in the $50 to $75 billion dollar range. Assuming the problem to be $60 billion and assuming a financing cost of 9% expenditures of $15.43 billion per year over the next 5 years would be required or expenditures of $9.35 billion per year for the next ten years.

Paying For the Solution to the Thrift Problem

At least three suggestions have been made for paying for the thrift problem; these are: 1. Let the thrift industry pay its own costs; 2. Merge FSLIC and FDIC and apply standardized premiums to all insured institutions; 3. Have the Treasury provide general funds for the resolution of the problem. I will limit myself to addressing the first proposal which is self funding of the problem by the healthy portion of the industry.

The healthy portion of the thrift industry cannot and should not be asked to solve the FSLIC's problems. The amount of funds necessary exceeds the total tangible net worth of $35 billion in healthy thrifts. If one assumes that the operating loss of insolvent thrifts will stabilize at a negative $6 billion per year this would require a yearly assessment of 72 basis points of insurance premium on the $832 billion of deposits held in GAAP solvent thrifts.

Competitive and Structural Problems

In addition to the acute problems associated with failed thrifts the industry is faced with a pervasive set of structural and competitive problems. Thrifts can be characterized as an industry searching for a business. The following table gives an indication of the earnings situation in thrifts.

All Thrifts

	1984	1985	1986	1987	1988
Net Operating Income/ Assets	10%	35%	.43%	.29%	.05%
Adjusted Net Income/ Assets	.17%	.28%	0.07%	(0.51)%	(1.19)%

GAAP Solvent Thrifts

	1984	1985	1986	1987	1988
Net Operating Income/ Assets	18%	59%	93%	.81%	.50%
Adjusted Net Income/ Assets	28%	66%	79%	46%	.27%

When the figures for all thrifts are examined it is clear that the industry is struggling, having achieved marginal net operating income in the last several years and actually experiencing net losses in total. Even when only GAAP solvent thrifts are examined neither the absolute level or trend of the numbers is reassuring.

There appear to be several causes for the inadequate performance of the thrift industry, these are 1. Eroding spreads between the thrifts traditional assets and the risk free returns earned on treasuries. 2. Increases in the cost of funds relative to treasury rates. 3. Escalating operating costs. 4. Increasing volatilities for both durations and yields on thrift assets and liabilities.

Chart 1 shows the spread between current coupon GNMA securities and the 10 year treasury rate. While the chart would indicate that spreads have remained relatively consistent I believe that other factors have effectively narrowed spreads. First the increasing capability of federal agencies and, perhaps to some extent, Wall Street has changed the balance between non-securitizable and securitizable loan production. As a greater percent of the industry's production has become securitizable the thrifts ability to earn a spread income has decreased. Second, it is possible that as interest rate volatility has increased the risk adjusted spread between mortgages and treasuries has decreased.

Chart 2 shows the trend in general and operating expenses of thrifts since 1971. The cost escalation since 1980 is substantial and in recent years G & A costs of associations have approximately doubled. The reason for cost increases has likely been a combination of the costs associated with offering new, and sometimes more costly, products and services and the costs of defending market share in a more deregulated and competitive market.

Chart 3 shows the relationship between the cost of savings deposits and the 3 month treasury bill rate. Since 1982 the cost of deposits has exceeded the 3 month treasury rate by an average of 107 basis points. The riskiest, or most aggressive, or weakest thrifts set the rates at the margin. The consumer is the lender of last resort. Because of federal insurance on deposits the consumer is driven to intelligently choose the highest paying thrift regardless of the prudence with which his funds will be deployed by the institution.

In short the thrift earned a large part of its income from assuming credit, liquidity, and interest rate risk in mortgage product. The increasing pervasiveness of federal agencies has removed much of the opportunity to earn returns from credit risk. The Agencies and Wall Street have liquified mortgage products to such an extent that the liquidity provided by thrifts is of less value. Interest rate risks have increased but the costs of thrifts bearing interest rate risks may have increased more rapidly than the revenues.

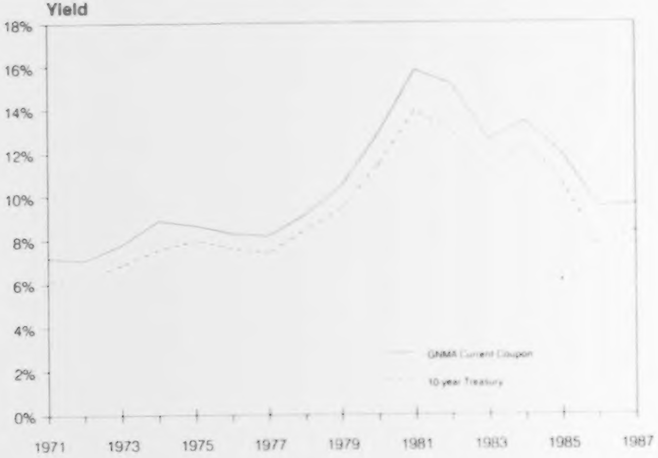
Other Structural Issues

Several other factors are to one extent or another exacerbating current problems.

1. The present accounting system does not provide adequate information for managerial or regulatory decision making.
2. All regulations which affect risk bearing should be under the purview of the FSLIC. State regulation which can affect FSLIC costs is anachronistic.
3. Insurance cost is based on insured deposits whereas risk to FSLIC is created by assets.
4. Using FSLIC insured funds to support secured borrowings increases risk to the FSLIC.
5. Government supported growth options for troubled thrifts in the form of risk controlled arbitrages at weak thrifts further threaten the thrift system through causing spread erosion.

Chart 1

GNMA Current Coupon vs. 10-year Treasury

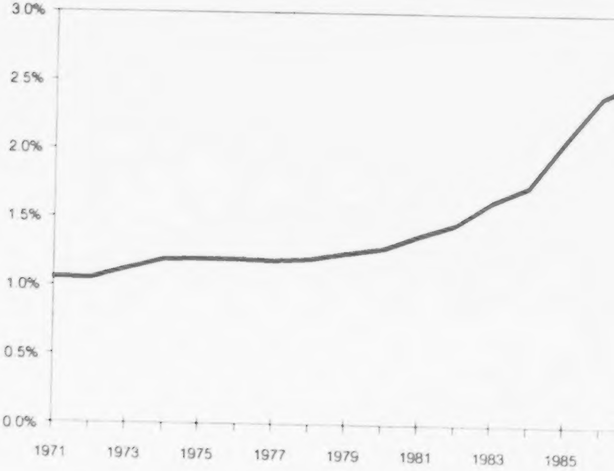


Economic Report of the President, February 1988

Data Resources Inc.

Chart 2

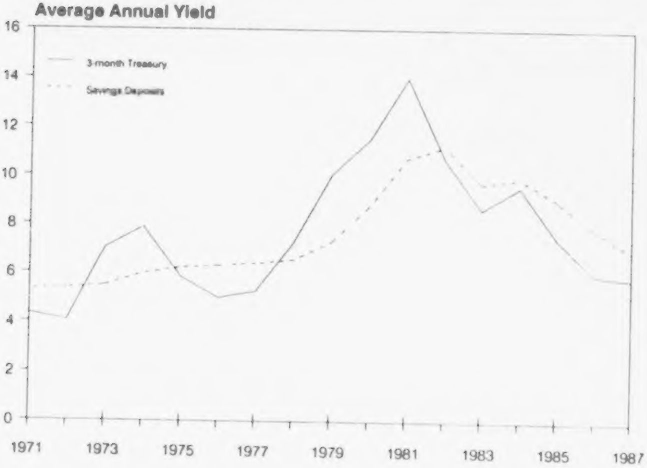
Operating Expenses of FSLIC-Insured Savings Institutions Divided by the Total Assets of All Insured Savings Intitutions



Savings Institutions Source Book
U.S. League of Savings Institutions, ©1988

Chart 3

Savings Deposits in FSLIC- Insured Savings Institutions vs. 3-month Treasury



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FEDERAL HOME LOAN BANK BOARD
1981 Final and Proposed Rules
(Beginning April 1)

FINAL RULES

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NOW accounts, ownership; final interpretive rule; repeal

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Mortgage loan contracts; inclusion of due-on-sale clauses; policy statement

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Balloon payment and reverse annuity mortgage loans

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Remote service unit operations; geographic restrictions

Savings account activity charges and small accounts

FEDERAL HOME LOAN BANK BOARD
1982 Final and Proposed Rules

DESCRIPTION	CITE
Final Rule: Amortization of Certain Discounts and Matching Losses, 12 C.F.R. Part 563c	47 Fed. Reg. 2857 (1-20-82)
Final Rule: Amortization Periods for Premiums, Discounts and Credits, and Treatment of Gains and Losses on the Sale of Real Estate, for Fiscal Years Ending on or After December 31, 1981, 12 C.F.R. 563, 563c	47 Fed. Reg. 3091 (1-22-82)
Final Rule: Consumer Leasing, 12 C.F.R. Parts 541, 545 and 561	47 Fed. Reg. 3541 (1-26-82)
Final Rule: Net Worth Amendment 12 C.F.R. Part 563	47 Fed. Reg. 3543 (1-26-82)
Final Rule: Amendments Relating to Issuance of Mutual Capital Certificates 12 C.F.R. Parts 544, 563, and 577	47 Fed. Reg. 4048 (1-28-82)
Final Rule: Amendments Concerning Borrowing, 12 C.F.R. Parts 544, 545, 561 563, and 571	47 Fed. Reg. 4049 (1-28-82)
Proposed Rule: Amendments Relating to the Issuance of Subordinated Debt Securities, 12 C.F.R. Parts 561 and 563	47 Fed. Reg. 8026 (2-24-82)
Final Rule: Delegation of Authority Regarding Merger Approvals, 12 C.F.R. Parts	47 Fed. Reg. 8152 (2-25-82)

The CHAIRMAN. Thank you very much, Chairman Pratt.

Before I recognize Chairman Gray, I understand that Senator D'Amato would like to be recognized for a unanimous consent request.

Senator D'AMATO. Mr. Chairman, I would ask unanimous consent that I might be permitted to submit my statement for the record as if read in its entirety.

The CHAIRMAN. Without objection, so ordered. I also would like to submit statements of Senators Shelby, Sasser, Dixon, Heinz, and Karnes.

[The statements follow:]

Richard Shelby

Statement by Senator Richard Shelby
Oversight Hearing on the Condition of the Thrift Industry
August 3, 1988

Mr. Chairman, I commend you for scheduling this fourth in the series of hearings on the condition of the thrift industry.

Yesterday's hearing brought out some interesting testimony. Industry representatives were not shy about placing most of the blame for the thrift crisis on the government: the Federal Home Loan Bank Board, the OMB, and the Congress. They also accused the trade associations for protecting the interests of the weak, rather than the interests of the industry as a whole.

Yesterday's witnesses may well be blameless. And government may well be guilty of losing its objectivity. Congress may have listened too closely to the loud voices of the trade associations. The OMB may have been too interested in promoting the philosophy of the Administration rather than providing for the effectiveness of the government watchdog. And the watchdog, the Federal Home Loan Bank Board, seems to have lost sight of its mission, which is **to regulate**, rather than to merely mediate between the desires of its industry and Congress.

It is important to identify the causes of the very expensive mess that we now find the thrift industry in.

WITHOUT SUCH AN UNDERSTANDING, WE ARE DOOMED TO REPEAT OURSELVES. HOWEVER, I DO NOT WISH TO SPEND THE LION'S SHARE OF THIS DEBATE ATTACHING BLAME TO ONE PARTICIPANT OR ANOTHER. I WOULD LIKE TO SEE THIS COMMITTEE DEVELOP A CLEAR SENSE OF EXACTLY WHAT MUST BE DONE TO EXTRICATE THE THRIFT INDUSTRY FROM THIS MESS. WITH THE USE OF THE WORD EXTRICATE, I DO NOT INTEND TO SUGGEST "BAIL OUT."

THE S & L INDUSTRY HAS WORKED ITSELF INTO THIS PROBLEM AND I SUPPORT EFFORTS THAT FORCE THE INDUSTRY TO PAY FOR THESE PROBLEMS. THE FSLIC UMBRELLA COVERS DEPOSITORS; IT IS NOT INTENDED TO REPRESENT A GOVERNMENT RELIEF PACKAGE WHENEVER PROBLEMS ARISE.

FROM TODAY'S WITNESSES, I WOULD LIKE TO HEAR SPECIFIC PROVISIONS THAT WILL HELP THE INDUSTRY, THE BANK BOARD, AND CONGRESS TO RESOLVE THE THRIFT INDUSTRY'S PROBLEMS. I BELIEVE THE DIFFICULTIES WE HAD IN PASSING A $10.6 BILLION DOLLAR BONDING AUTHORITY BILL FOR THE FSLIC LAST SUMMER WILL PREVENT TODAY'S WITNESSES FROM SUGGESTING A $40 OR $50 BILLION DOLLAR TAXPAYER BAILOUT.

IN MY OPINION, THE USE OF TAXPAYER MONEY IS NOT A SOLUTION. CHAIRMAN GRAY'S TESTIMONY ATTRIBUTES GOVERNMENT'S FAILURE TO LEGISLATE, AUTHORIZE, AND **REGULATE** APPROPRIATELY TO THE DIVERGENCE OF PAROCHIAL INTERESTS AMONG THE VARIOUS PLAYERS. WE NO LONGER HAVE TIME FOR THAT. IT IS TIME TO BURY ANY

DIFFERENCES OF OBJECTIVE OR MOTIVE AND DEVELOP A COMPREHENSIVE STRATEGY TO RESOLVE THE THRIFT CRISIS. I LOOK FORWARD TO THE TESTIMONY OF OUR WITNESSES.

THANK YOU, MR. CHAIRMAN.

Jim Sasser

STATEMENT OF SENATOR JIM SASSER, SENATE BANKING COMMITTEE, AUGUST 3, 1988

MR. CHAIRMAN, I WANT TO AGAIN THANK YOU FOR SCHEDULING THESE HEARINGS, AND CONTINUING TO FOCUS ATTENTION ON THIS CRITICAL ISSUE.

THE COMPLEXITY OF THE PROBLEM, THE MULTITUDE OF CAUSES, AND THE UNCERTAINTY AS TO THE SCOPE, MAKE IT IMPERATIVE THAT WE GET A HANDLE ON IT AS QUICKLY AS POSSIBLE. IN THIS RESPECT, I APPRECIATE THE SUPPORT THAT YOU AND THE COMMITTEE HAVE GIVEN TO THE COMMISSION BILL THAT SENATOR GRAHAM AND I INTRODUCED.

INDEED, I NOTICE THAT AT LEAST ONE OF TODAY'S DISTINGUISHED WITNESSES IS ENDORSING THE ESTABLISHMENT OF A BLUE RIBBON COMMISSION TO LOOK AT THE FSLIC CRISIS, AND MAKE RECOMMENDATIONS FOR APPROPRIATE ACTION BY CONGRESS.

MR. CHAIRMAN, I THINK IT'S IMPORTANT TO MOVE THIS BILL RIGHT AWAY AND GET THE COMMISSION ROLLING. MOREOVER, I WOULD SUPPORT ADVANCING THE DATE OF SUBMISSION OF THE REPORT UP FROM THE CURRENT MARCH 15, 1988.

IF THE NEC REPORT IS DUE MARCH 1; LET'S MAKE OURS DUE FEBRUARY 1 OR JANUARY 15 -- SO THAT WE CAN GET STARTED ON A COMPREHENSIVE, AND LONG-TERM SOLUTION, VERY EARLY IN THE YEAR.

AND WE SHOULD EXPLORE ANY AVENUE THAT WE CAN RIGHT NOW, IN THE SHORT-TERM. I UNDERSTAND THAT YOU HAVE SOME IDEAS, MR. CHAIRMAN; I AM ANXIOUS TO DISCUSS THEM WITH YOU.

WE HAVE HEARD SO MUCH, FOR SO LONG, FROM SO MANY DIFFERENT SOURCES ON THIS SUBJECT. I THINK WE NEED TO HAVE A GROUP OF EXPERTS, TAKE A GOOD HARD LOOK AT THE QUESTION. I HAVE GREAT CONFIDENCE IN THIS COMMITTEE AND ITS STAFF, BUT THIS IS A COLLOSSAL ISSUE.

THE FSLIC IS LOSING $1 BILLION PER MONTH. THE ESTIMATES OF THE TOTAL LIABILITY WILL NO DOUBT BE UP AROUND $100 BILLION VERY SHORTLY. AND THERE IS VERY LITTLE TIME LEFT IN THIS SESSION.

MR. CHAIRMAN, I THANK YOU AGAIN FOR CALLING THIS HEARING, AND LOOK FORWARD TO THE TESTIMONY OF THE DISTINGUISHED PANEL.

AUGUST 3, 1988

Alan J Dixon

STATEMENT OF SENATOR ALAN DIXON

SENATE BANKING COMMITTEE HEARING
ON
THRIFT INDUSTRY ISSUES

MR. CHAIRMAN, I AM PLEASED TO BE HERE THIS MORNING AS THE SENATE BANKING COMMITTEE CONTINUES ITS OVERSIGHT HEARINGS ON ISSUES AFFECTING THE THRIFT INDUSTRY AND THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION. WE HAVE AN EXPERT GROUP OF WITNESSES BEFORE US TODAY, AND I LOOK FORWARD TO THEIR TESTIMONY.

THESE HEARINGS WILL NOT PRODUCE LEGISLATION THIS YEAR. FOR A VARIETY OF REASONS, ACTION WILL LIKELY NOT OCCUR UNTIL SOMETIME IN THE NEXT CONGRESS. HOWEVER, I AM CONVINCED THAT THERE IS A NEED FOR COMPREHENSIVE LEGISLATION. ANY SOUND PACKAGE WILL HAVE TO ADDRESS MUCH MORE THAN JUST FSLIC; IT WILL ALSO HAVE TO ADDRESS THE REGULATORY AND SUPERVISORY PROBLEMS THAT CONTRIBUTED

Proposed Rule: Transfer and Repurchase of Government Securities, 12 C.F.R. Parts 531 and 563	47 Fed. Reg. 8204 (2-25-82)
Proposed Rule: Amendments on Forward Commitments, Financial Options Trading, and Financial Futures Trading, 12 C.F.R. Parts 545 and 563	47 Fed. Reg. 9472 (3-8-82)
Proposed Rule: Service Corporation Activities, 12 C.F.R. Part 545	47 Fed. Reg. 9855 (3-8-82)
Final Rule: Manufactured Home Loans, 12 C.F.R. Parts 545, 555, 561 and 584	47 Fed. Reg. 10785 (3-12-82)
Final Rule: Amendment of Regulations Regarding Charter Conversions for Supervisory Purposes, 12 C.F.R. Part 576	47 Fed. Reg. 10788 (3-12-82)

DESCRIPTION	CITE
Proposed Rule: FSLIC Insurance Coverage of Deferred Compensation Plans, 12 C.F.R. Parts 561 and 564	47 Fed. Reg. 10858 (3-12-82)
Final Rule: Revision of Application Requirements for Corporate Titles and Office Relocations, 12 C.F.R. Parts 543, 544, 545, 552, and 577	47 Fed. Reg. 13505 (3-31-82)
Final Rule: Annual Credit to Secondary Reserve, 12 C.F.R. Part 563	47 Fed. Reg. 13509 (3-31-82)
Final Rule: Amendments Relating to Savings Accounts, 12 C.F.R. Parts 526, 544, 545, 555, 561, 563, and 564	47 Fed. Reg. 13776 (4-1-82)
Final Rule: Federal Home Loan Bank Advances Secured by Federal Savings and Loan Insurance Corporation Obligations, 12 C.F.R. Part 525	47 Fed. Reg. 16316 (4-16-82)
Proposed Rule: Monitoring Fair Lending Practices, 12 C.F.R. Part 528	47 Fed. Reg. 16633 (4-19-82)
Final Rule: Correspondent Activities of Federal Associations, 12 C.F.R. Part 545	47 Fed. Reg. 17468 (4-23-82)
Final Rule: Employment Contracts, 12 C.F.R. Parts 545, 563, and 571	47 Fed. Reg. 17471 (4-23-82)
Temporary Final Rule: Organization, Merger and Acquisition of Interim Savings and Loan Associations, 12 C.F.R. Parts 541, 543, 545, 552, 562, 563, and 583	47 Fed. Reg. 17797 (4-26-82)

Final Rule: Expanded Merger Delegation Regulation, 12 C.F.R. Parts 546 and 563	47 Fed. Reg. 17801 (4-26-82)
Proposed Rule: Processing of Applications, 12 C.F.R. Parts 543, 545, 546, 552, and 563	47 Fed. Reg. 17999 (4-27-82)
Final Rule: Securities of Insured Institutions, 12 C.F.R. Part 563d	47 Fed. Reg. 18327 (4-29-82)
Final Rule: Delegation of Authority Regarding Trust Powers Applications, 12 C.F.R. Part 550	47 Fed. Reg. 19115 (5-4-82)
Proposed Rule: Branching in Connection with Supervisory and Non-Supervisory Mergers and Acquisitions, 12 C.F.R. Part 556	47 Fed. Reg. 19154 (5-4-82)

DESCRIPTION	CITE
Proposed Rule: Home Loan Amendments; Adjusted New Worth, 12 C.F.R. Parts 545, 555, 561, and 570	47 Fed. Reg. 18711 (5-7-82)
Final Rule: Conversions from Mutual to Stock Form, 12 C.F.R. Part 563b	47 Fed. Reg. 19672 (5-13-82)
Proposed Rule: Amendments Relating to Change in Control, 12 C.F.R. Part 563	47 Fed. Reg. 20616 (5-13-82)
Final Rule: FSLIC Insurance Coverage of Deferred Compensation Plans and IRA and KEOGH Accounts, 12 C.F.R. Parts 561 and 564	47 Fed. Reg. 20748 (5-14-82)
Proposed Rule: Information Disclosure Requirements in Connection With Conversions From the Mutual to the Stock Form of Organization, Filings Under the Securities Exchange Act of 1934, and the Issuance of Mutual Capital Certificates and Debt Securities, 12 C.F.R. Parts 563b, 563c and 563d	47 Fed. Reg. 21056 (5-17-82)
Final Rule: Accounting For Gains and Losses Dispositions and for Discounts From Acquisitions of Mortgage Loans and Certain Securities, 12 C.F.R. Part 563c	47 Fed. Reg. 22346 (5-24-82)
Final Rule: Transfer and Repurchase of Government Securities, 12 C.F.R. Parts 531 and 563	57 Fed. Reg. 23140 (5-27-82)
Final Rule: Conversion From Mutual to Stock Form; Technical Amendments, 12 C.F.R. Part 563b	47 Fed. Reg. 24252 (6-4-82)
Final Rule: Delegated Authority in Connection	47 Fed. Reg.

With Mergers, 12 C.F.R. Parts 546 and 563	26807 (6-22-82)
Proposed Rule: Service Corporation Activities, 12 C.F.R. Part 545	47 Fed. Reg. 28110 (6-29-82)
Proposed Rule: Amendments Relating to the Issuance and Use of Subordinated Debt Securities, Mutual Capital Certificates, and Preferred Stock, 12 C.F.R. Parts 561 and 563	47 Fed. Reg. 29558 (7-7-82)
Final Rule: Amendments Relating to Calculation of the Net-Worth Requirement, 12 C.F.R. Part 563	47 Fed. Reg. 31859 (7-23-82)
Final Rule: Amendments Relating to Change in Control, 12 C.F.R. Parts 509 and 563	47 Fed. Reg. 34120 (8-6-82)

DESCRIPTION	CITE
Final Rule: Amendments to Policy Statement concerning Branching in Supervisory and Non-Supervisory Acquisitions, 12 C.F.R. Part 556	47 Fed. Reg. 34125 (8-6-82)
Proposed Rule: Liquidity Amendments, 12 C.F.R. Parts 523, 545, and 563	47 Fed. Reg. 34152 (8-6-82)
Final Rule: Authority for Federal Associations to Act as Depository and Fiscal Agent of the Government, 12 C.F.R. Parts 523, 526, 545, 561, 563, and 564	47 Fed. Reg. 36610 (8-23-82)
Final Rule: Home Loan Amendments; Adjusted Net Worth, 12 C.F.R. Parts 545, 555, 561, 563, and 570	47 Fed. Reg. 36612 (8-23-82)
Final Rule: Financial Options Trading, 12 C.F.R. Parts 545 and 563	47 Fed. Reg. 36621 (8-23-82)
Final Rule: Issuance and Use of Subordinated Debt Securities, Mutual Capital Certificates, and Preferred Stock, 12 C.F.R. Parts 561 and 563	47 Fed. Reg. 39661 (9-9-82)
Proposed Rule: Amendments to Net Worth and Statutory Reserve Requirements, 12 C.F.R. Parts 541, 561 and 563	47 Fed. Reg. 39692 (9-9-82)
Proposed Rule: Processing of Applications, 12 C.F.R. Parts 543, 545, 546, 552, and 563	47 Fed. Reg.

Congress and the regulators face a daunting task in the resolution of the problems of the thrift industry and other insured depository institutions. The thrift industry is at an evolutionary crisis. The problems of the thrift industry are not attributable to the individual actions of management, the regulators or Congress, but stem from the challenges of adaptation by a network of highly complex, well-entrenched bureaucracies. The congruity of deregulation, technological change, regional depression and inadequate information systems have come together to test the survival of the thrift industry and its associated regulatory structure in its present form.

The immediate solution will be costly and, regardless of the differences in estimates, the numbers are surprisingly large. The short-run question is simply one of how the solution to the problem will be financed and how the mechanical components will come together in a timely fashion to provide the solution.

In a long-run sense, major structural reform is necessary if future problems are to be avoided. Congress must address the issue of the purpose of deposit insurance and the role which various insured depository institutions will play in the nation's economy. The question of insurance structure must be addressed and the advisability of separate versus merged insuring institutions, management information and accounting systems must be updated to provide a clear indication of the health and direction of insured institutions.

Insurance systems must be reformed. The present insurance systems are not actuarily sound and have no basis in providing insurance costs which are actuarily related to the risks of the insuring agency. Under the present system, an inordinate burden is placed upon regulation and supervision to insure that many institutions act in a manner inconsistent with the private interests of those institutions and counterproductive to their shareholders' interest. The insurance and regulatory scheme must be formulated in such a fashion that institutions acting in their own self-interest are not incented to act in a socially non-productive fashion. The present juxtaposition of public interests and self-interest will create a spiralling need for examination and supervision which will not adequately control risk and which will greatly defeat the benefits which can be achieved from our national depository institutions. The refocusing and redirecting requirements are massive, but a failure to act at this time will perpetuate and exacerbate the problems associated with insured financial institutions.

TO THE PROBLEMS FSLIC AND THE THRIFT INDUSTRY ARE FACING. IT WILL HAVE TO REIN IN THE EXCESSES THAT HAVE OCCURRED IN SOME STATES. THE FEDERAL INSURANCE PROGRAM CANNOT BE EXPECTED TO COVER ANY RISKS THE STATES MAY EXPLICITLY OR INADVERTENTLY CREATE FORE THE INSURANCE FUND WITHOUT HAVING SOME VOICE IN THOSE DECISIONS, OR AT LEAST WITHOUT THE ABILITY TO CHARGE INSURANCE PREMIUMS THAT ADEQUATELY COMPENSATE FOR THOSE RISKS.

WHILE LEGISLATIVE ACTION WILL NOT OCCUR UNTIL THE NEXT CONGRESS, WE NEED TO BEGIN THE PROCESS OF PUTTING THE BILL TOGETHER NOW. I WANT TO CONGRATULATE THE CHAIRMAN, THEREFORE, FOR HIS LEADERSHIP IN THIS AREA. I LOOK FORWARD TO WORKING WITH HIM AND ALL INTERESTED PARTIES AS WE WORK TOWARDS THE KIND OF SOUND OMNIBUS LEGISLATION THAT IS NEEDED.

STATEMENT OF THE HONORABLE JOHN HEINZ
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
AUGUST 3, 1987

MR. CHAIRMAN FOR THE PAST TEN YEARS THE THRIFT INDUSTRY HAS BEEN IN A RACE FOR SURVIVAL. DURING THE COURSE OF THAT RACE THE INDUSTRY HAS HAD TO JUMP MANY HURDLES INCLUDING THE SPIRALING INTEREST RATES OF THE LATE 1970'S AND THE PLUNGING OIL PRICES OF THE MID-1980'S.

TODAY WE WELCOME THREE FORMER CHAIRMEN OF THE FEDERAL HOME LOAN BANK BOARD. EACH OF THESE GENTLEMEN HAS CARRIED THE BATON IN THIS RACE.

BETWEEN 1979 AND 1980, THE BATON WAS CARRIED BY JAY JANIS. HE HAD TO JUMP THE HURDLE OF DEPOSIT INTEREST RATE DEREGULATION. THAT HURDLE WAS CLEARED IN 1980 WHEN CONGRESS PASSED THE DEPOSITORY INSTITUTIONS DEREGULATION AND MONETARY CONTROL ACT. IN 1981, CHAIRMAN JANIS RAN TOWARDS THE NEXT HURDLE; THE DEREGULATION OF THRIFT ASSETS.

BEFORE THAT HURDLE WAS CROSSED, THE BATON WAS PASSED TO RICHARD PRATT. HE SOARED OVER THE HURDLE OF DEREGULATION IN 1982 WHEN CONGRESS PASSED THE GARN ST-GERMAIN DEPOSITORY INSTITUTIONS ACT. WITH THE DEREGULATORY WIND AT CHAIRMAN PRATT'S BACK, THE THRIFT INDUSTRY STARTED GATHERING STEAM. SOME STATES, UNHAPPY WITH THE

PACE SET AT THE FEDERAL LEVEL, CHARTERED THRIFTS WITHOUT SETTING ANY SPEED LIMITS.

BY THE TIME THE BATON WAS PASSED TO EDWIN GRAY IN 1983, THE INDUSTRY'S GROWTH WAS FULL SPEED AHEAD. HOWEVER, THE INDUSTRY WAS OUTRUNNING THE REGULATOR. CONCERNED THAT THE INDUSTRY WAS HEADING DOWNHILL, CHAIRMAN GRAY PUT OUT THE CAUTION FLAG AND APPLIED THE BRAKES.

BY THEN, CHAIRMAN GRAY SAW THE HURDLES LOOMING JUST AHEAD. THE PRICE OF OIL DROPPED AND TOOK REAL ESTATE PRICES ALONG WITH IT. THE STATE THRIFTS THAT HAD RACED AHEAD IN 1983 WERE COLLAPSING FROM FINANCIAL EXHAUSTION IN 1985.

MR. CHAIRMAN, THE HURDLES THAT THESE GENTLEMEN FACED IN THE PAST TEN YEARS HAVE NOW PILED UP. STACKED ONE UPON ANOTHER THESE HURDLES FORM A MULTI-BILLION DOLLAR MOUNTAIN OF RED INK.

AS WE ALL KNOW, THE BATON THESE CHAIRMEN CARRIED WAS THE SYMBOL OF FEDERAL DEPOSIT INSURANCE. NOW, THE BATON HAS BEEN PASSED ON TO US.

THIS RACE MUST BE FINISHED, AND IT MUST BE FINISHED SOON. THE LONGER WE WAIT THE HIGHER THAT MOUNTAIN GROWS.

NO DOUBT THE LAST LEG OF THIS RACE WILL BE PAINFUL. BUT WHAT IS AT STAKE IS OUR NATION'S CONFIDENCE IN THE DEPOSIT INSURANCE SYSTEM. IT IS A PRIZE THAT WE CANNOT AFFORD TO LOSE.

ONCE THE RACE IS OVER, WE MUST MAKE CERTAIN THAT THE THRIFT INDUSTRY IS PLACED FIRMLY ON A LEVEL TRACK. AS IMPORTANT, WE MUST MAKE CERTAIN THAT THE RUNNERS STAY ON COURSE.

STATEMENT OF SENATOR D'AMATO
AUGUST 3, 1988

TODAY'S HEARINGS PRESENT US WITH THE OPPORTUNITY TO CONSIDER THE REGULATORY ASPECT OF THE THRIFT INDUSTRY. YESTERDAY'S WITNESSES POINTED TO FAILURES OF REGULATION AS A SIGNIFICANT FACTOR CONTRIBUTING TO THE CURRENT THRIFT PROBLEM. TODAY'S PANEL WILL NO DOUBT REFUTE SOME OF THAT CRITICISM AND POINT OUT, CORRECTLY, THAT THE CURRENT SITUATION RESULTED FROM DRAMATIC CHANGES IN THE ECONOMY AND IN THE THRIFT INDUSTRY, AS WELL AS FAILINGS BY EVERY PARTY, INCLUDING THE ADMINISTRATION AND THE CONGRESS.

HOWEVER, I HOPE WE DO NOT SPEND TOO MUCH TIME POINTING FINGERS. ON THE REGULATORY FRONT IN PARTICULAR WE HAVE A NEW PROGRAM IN PLACE. THE BANK BOARD DOES NOT HAVE THE LEVEL OF RESOURCES AT ITS DISPOSAL THAT IT SHOULD HAVE, BUT IT HAS STAY TO WORK WITH.

I HOPE OUR DISTINGUISHED PANEL CAN HELP US TODAY TO EVALUATE THE PROSPECTS FOR SUCCESS OF OUR CURRENT REGULATORY PROGRAM. IN PARTICULAR, THE SOUTHWEST PLAN OFFERS HOPE FOR A PURPOSEFUL, SUSTAINED REGULATORY EFFORT IN AN AREA OF THE COUNTRY WHERE THE PROBLEM IS THE GREATEST.

YESTERDAY, MR. GOULD SPEAKING FOR THE ADMINISTRATION, EMPHASIZED THAT THE BANK BOARD HAS SUFFICIENT FUNDING TO RESOLVE AS MANY CASES AS IT CAN EFFICIENTLY HANDLE. UNLIKE MANY PROPONENTS OF A DRASTIC TAXPAYER FUNDED SOLUTION, I HAVE NOT GIVEN UP ON THE BANK BOARD, THE FSLIC AND THE HEALTHY PORTION OF THE INDUSTRY. I HOPE TODAY'S WITNESS, SINCE THEY NOW HAVE THE ABILITY TO REFLECT THE INDUSTRY'S PERSPECTIVE ON THEIR FORMER HOMES AT THE BANK BOARD, CAN OFFER SOME GUIDANCE ON REGULATORY SOLUTIONS TO THIS PROBLEM.

STATEMENT OF SENATOR DAVID KARNES

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

AUGUST 3, 1988

Mr. Chairman, this morning the Committee will be giving additional consideration to the conditions within the thrift industry, what factors have led to those conditions, and what steps need to be taken to address the problems that exist. As I I have said on many occasions, my major objective is to address the important issue of attracting and retaining capital in our nation's savings and loans industry. I appreciate your efforts and those of Senator Garn, the ranking minority member of the Committee, in continuing to focus this Committee on the critical issues facing the industry.

I am interested, as I know my colleagues on this Committee are, in seeing that thrifts are there to serve an important and growing part of our economy. That is why I took the lead in the Senate in introducing S. 2073, the Thrift Charter Enhancement Act. I appreciate the expeditious nature with which the committee considered the legislation and hope that the full Senate will have the opportunity to consider the merits of the legislation at the earliest possible date.

I would close my remarks by noting the excellent testimony delivered yesterday by both Undersecretary Gould and the three panelists within the industry. I was particularly struck by Mr. Gould's call for us to resist the mounting pleas for an unnecessary taxpayer bailout. I agree that until and unless this committee and the Congress working with the Administration have exhausted all other alternatives, no taxpayer bailout should be considered. I could not agree more with Underscretary Gould's statement that all existing resources, including those of the Federal Home Loan Bank System, should be considered before any possible draw on the Treasury is even discussed.

I also want to compliment you Mr. Chairman for the excellent witnesses you have assembled over the past two days and want to welcome the three former Chairman of the Federal Home Loan Bank Board. I look forward to their testimony on this very significant problem.

Thank you Mr. Chairman.

The CHAIRMAN. Chairman Gray.

STATEMENT OF EDWIN J. GRAY, PRESIDENT AND CHIEF OPERATING OFFICER, CHASE FEDERAL BANK, MIAMI, FL

Mr. GRAY. Thank you very much, Mr. Chairman. It's an honor and a privilege to be here with all of you, and especially you, since you will not be chairman or a Member of the Senate in a while. I appreciate, as Dick has expressed, all of your help and support and this would apply to everybody sitting up there over a long period of time.

I served as Chairman of the Federal Home Loan Bank Board longer than any of my predecessors except for three, the longest serving Chairman since the 1950's. And when I came yesterday to the hearing, I came in late, but I heard some of the comments being made. I must say that I wondered where everybody had been. I heard some of the same suggestions which I had been making 4 years ago or 3 years ago being made today, suggestions as to how to deal with this problem, some of which I'll go through and, of course, you have a lot of them in my prepared statement.

There is a lot of revisionist history going on right now about the thrift problem and that bothers me a lot because I was around. So I'm going to spend most of my time in this oral presentation about how we got here.

HOW WE ARRIVED AT THIS POINT

When I became Chairman, the minimum net worth requirements for thrifts had been dropped from 5 percent to 3 percent. We had accounting devices which rendered these minimum capital requirements absolutely meaningless. We had 5 year averaging, 20 year phase-in. We had loan loss referral accounting, et cetera.

So we started with nothing. I became very concerned about the new aspect of deregulation which provided that as many funds as an institution wanted could come in, supplied by the money broker community. Within 4 months of the time I became chairman I began warning about this problem. And I think it would be instructive for you who were here and especially for some of you who were not here to know what I was saying at the time to you, to the industry, and to the financial community.

I said, for example, on October 7, 1983, to the House Banking Committee:

> In light of the rapid growth in third party money brokering, I would urge that the Congress revisit the whole matter of what Federal deposit insurance is and what it ought to be and what it ought to be used for in the future. The issues for deposit insurance are of such magnitude that I believe they ought to be addressed and resolved in the legislative process.

I addressed the National Savings and Loan League on January 31, 1984 and at that time I said:

> Money brokering may already have begun to jeopardize the future viability of the Federal deposit insurance system.

These are words that I used myself. I'm not summarizing.

I want to go through what I also said at that time. I said:

> I could cite a litany of horror stories which have been turned over to the FSLIC in recent weeks. All of them are substantially attributable to the use of easy money

> received from money brokers. The regulator discovers the consequences of such actions within a matter of months, but by then it's too late. The only way the Federal regulatory agencies could possibly keep up with the situation would be to place an examiner or supervisory official at every institution to oversee and monitor the rapidity of transactions based on the easiest conceivable access to money.

I said:

> Allowing this to happen would either result ultimately in destroying the funds themselves or threatening to exhaust the resources of the insurance fund sooner or later. The situation would require substantial infusions of funds from the U.S. Treasury and hence the Nation's taxpayers.

Mind you, I'm talking about this on February 16, 1984. I went on to say to the National Council of Savings Institutions:

> It's important for the Congress to recognize the possibility of having to cause an infusion of funds from the Treasury and without firm corrective action this could result in such Treasury infusions in the future.

I said:

> We believe the future viability of the Federal deposit insurance system could be gravely threatened, so much so that massive infusions from the Treasury and hence the taxpayers could well be required to support the deposit insurance function.

At a U.S. League meeting that was held in March 1984, I said:

> I was frankly shocked by the passivity, the misunderstanding as to the high stakes implications for the industry and the deposit insurance fund as a result of this trafficking in fast growth deposits. It is time that you in the industry wake up to the stakes this issue poses for your future. If you don't, you will have only yourselves to blame.

Now I have in the material that was provided to the committee and others 80 pages of things I said, actual words that I used during my chairmanship, and I think it would be instructive, particularly for those who may be influenced too much by the historic revisionism that we've been hearing about the origins of this crisis to go through and recall exactly what we were saying. Brokered funds were providing a source of outflows for the direct investments that you and I have been concerned about for so long, Mr. Chairman, and frankly that's where most of our problems today are in terms of the losses.

So we recognized early on that with the advent of deregulation this was going to be a terrible problem and we tried very hard to do something about it. Let me go on further.

When the district court and then the appeals court determined that we had exceeded our statutory authority, we at that time sent legislation to the Congress and said, "Clarify this so we can put this into effect." There was such a lack of understanding at the time of the seriousness of this, that nothing was done, and this is probably the story of these failures as you look down through time.

We had to go back to square one and we adopted the so-called growth regulation, and direct investment regulation. We developed them in the fall of 1984, and proposed them in December 1984. Just to give you an example of the pressure that was on us at the Bank Board, I was told by a number of the most senior members of the organized thrift industry that my own career when I returned to the savings and loan business would be jeopardized and that it might be ruined. But I said, "If I have to be the SOB to do it, we'll do it," and we did it.

We put into effect the growth and direct investment regulations in early 1985.

Now we've done a lot of other things. I've outlined them in the testimony. We have improved the accounting of the Bank Board during my tenure. We did a lot of things. But there was such a misunderstanding that I think some people thought I was crazy back when we were warning about the implications for what was going on for the future of the deposit insurance system and particularly the exposure that the taxpayers would have to this problem.

Now I can't tell you today how big the problem is. I wish I could. When I left I believed it was a $30 billion problem. My own calculations indicate that if I projected what I thought at the time it would be $40 but it could be well over that.

To prevent a recurrence of this problem is very important. I was urging that the thrift fund be recapitalized, using the Treasury-Bank Board plan, beginning in early 1986. I was saying at that time and all the way through that this money is not going to make any difference if we don't get to the real heart of the problem and if we don't understand in this industry the need for safety and soundness and prudence. These concepts are as old as banking itself. Unfortunately, many in this industry didn't consider them along the way.

Now I want to just finish by saying this. I believe that because we got virtually no support from the organized thrift industry during the entire time that I was Chairman of the Bank Board and because all of the legislation that we sent to Congress was killed by organized thrift industry lobbyists—and here I want to differentiate between organized industry—that is to say the trade associations—and the industry itself made up of a lot of individual members. The organized industry really brought this problem that we're facing today on themselves. It's a self-inflicted wound and it's a terrible wound, and, of course, it's happened at the expense of the taxpayers if we in fact have to use taxpayer money to deal with this problem.

So I would say there are a lot of reasons why the problem occurred, but it's very unfortunate that we did not get the kind of support we needed from the organized industry itself.

Thank you very much.

[The complete prepared statement of Mr. Gray follows:]

STATEMENT

OF

EDWIN J. GRAY, PAST CHAIRMAN

FEDERAL HOME LOAN BANK BOARD

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

OF THE

UNITED STATES SENATE

WASHINGTON D.C.

AUGUST 3, 1988

Mr. Chairman and distinguished members of the Committee:

It is a privilege to be able to appear before you again. The thirteen months since I've gone have provided an opportunity to reflect on my former experiences as a financial regulator.

I've compiled some excerpts of what I told Congress and what I said to other groups during the course of my tenure at the Bank Board. I've put them in an **Addendum 1** which is attached to this statement and which I'll refer to from time to time. I hope very much that you can read through it.

You have asked, Mr. Chairman, that I direct my comments to the following areas:

I.) How the industry deteriorated to its present position;

II.) The size of the bill that will need to be paid;

III.) What should be done to protect depositors and prevent a recurrence of this problem?

HOW THE INDUSTRY DETERIORATED TO ITS PRESENT POSITION

In the early 1980s, when high interest rates caused many thrift institutions to pay more for savings deposits than they were earning on their long-term, fixed-rate mortgage loan portfolios, the industry as a whole lost nearly all of its tangible net worth, or capital.

In the 1960s and 70s, the industry sought -- on many occasions -- the opportunity to tie home mortgage rates to the fluctuating costs of money, or deposit rates.

It was not until 1981, however, that the ability to make fully adjustable rate mortgages was finally made available to thrifts.

By 1981, it was too late. Many thrift institutions had built up enormous long-term, fixed-rate mortgage portfolios over the years -- because they had never been authorized to make fully adjustable rate loans. These fixed-rate loan portfolios quickly became underwater portfolios, drowning under negative spreads. The so-called "spread" problems of 1981 and 1982 caused one-fifth of the institutions in the thrift industry either to be closed or to be merged into other savings institutions.

In retrospect, these "spread" problems were the sort of problems the FSLIC could deal with. It was the "asset quality" problems which were to come which would so devastate the FSLIC.

The passage of the Garn-St Germain Depository Institutions Act of 1982 was seen as an appropriate response to the problems of the industry. The Act was a follow-up to the Depository Institutions Deregulation and Monetary Control Act of 1980.

The Garn-St Germain Act, "helped along" by a Depository Institutions Deregulation Committee (The DIDC) which aggressively sought to accelerate removal of rate controls on deposits at insured thrifts and commercial banks, provided institutions the authority to immediately begin offering a Money Market Deposit Account (MMDA) free of rate controls.

This authority, along with the very aggressive pursuit of rate control removal on other deposit accounts, sent what was interpreted by many to be a clear signal that the "deregulation of liability instruments" was "indeed and absolutely" **the law of the land**. And, if that were really true, then asset deregulation must also be an honest-to-God reality. If there had been any doubts, it was "surely understood by everyone" that the doubts were no longer warranted.

The confluence of very new forces and very new perceptions in and out of the thrift industry set the stage for the development of the present thrift crisis. This, of course, was an industry which, until 1980, had been largely limited to making home mortgages and to some degree home improvement loans.

Some states passed, or were in the process of strengthening, laws which allowed their own state-chartered thrifts to engage in activities which went far beyond what Congress had authorized for federally-chartered savings institutions in the Garn-St Germain Act. For example, a 1982 California law gave its state-chartered thrifts authority to do anything and everything they wanted to do -- no holds barred -- using federally-insured deposits. The California state savings and loan commissioner's examination/supervision staff had been decimated by budget cuts; examiners and supervisors could be counted by the handsfull. Yet, the state was the principal regulator for the largest and fastest growing stable of thrift institutions in the nation, and now they had virtually unlimited financial powers -- far beyond anything which any federally-insured depositories had ever known (or may ever know).

At the same time there was, with the **advent** of thrift deregulation (1982 and 1983), a widespread notion that pervaded the thrift industry and some quarters of the government that the thrift regulator was being relegated to a significantly lessor role -- relative oblivion some believed. Deregulation was, after all, **the law of the land,** wasn't it?

To many in an industry which had been highly regulated over the years -- by a myriad of regulations -- "deregulation" was seen as putting an end to such regulation, that is to say, rulemaking.

In other words, the regulator -- in this new era of **de**-regulation -- was to be seen little and heard from less, and only, really, in an advocacy role with Congress and the public to press the interests of the thrift industry. Not everyone in the industry shared this basic view, of course, but many did, to a lesser or greater extent.

When there were problems (negatives) in the thrift industry the regulator was supposed to be quiet. A big part of his or her job was seen as being a "cheerleader" for the industry. This was a widely-shared view of members of the thrift industry. (My own views on the appropriate role of the regulator are expressed in many parts of Addendum 1, but **most** cogently on Pages 78 and 79.)

The perceptions and expectations for the role of regulation at the time **de**-regulation entered the scene had a considerable effect on the behavior of some in the industry. Indeed, it was strongly affecting the behavior of state legislatures who seemingly were running at fullspeed to liberalize operating authorities for state-chartered thrifts. The "deregulatory" mentality of the time was widespread and pervasive.

One thing was certain. The industry did **not** want a so-called "**re**-regulator" in an era of **de**-regulation. This cut against the grain of the fashion of the new era. Indeed, it was not until the talk of, and yes widespread recognition of, great problems at the FSLIC (mid 1986 on) that the term "re-regulator" began disappearing from the lexicon of fashionable financial terms.

In my own view, what happened with, and after, the advent of thrift deregulation was, at least in broad terms, the following:

1) A regulatory apparatus which had been fashioned over the years to monitor and police the activities of a highly-regulated industry committed to the home mortgage business was instantly being called upon to monitor and police the safety and soundness of a deregulated thrift system which was employing entirely different financial instruments and highly diverse (state and federal) operating authorities.

   Under the circumstances, the regulatory apparatus had little chance. It was no match for the realities of the new deregulated thrift environment. Very little of anything had been done to prepare the thrift regulatory system for its new and overwhelming obligations.

   In effect the regulatory police department, so to speak, had been designed to serve a small community of 20,000, where life was simple. But, it was faced, immediately, with the huge task of policing the complexities of 10 New York Citys. I sometimes felt like a sheriff without a gun.

   At this juncture, the thrift regulatory system didn't have the people, didn't have the equipment, didn't have the tools to effectively police the new environment, and worst of all, it didn't have enough tangible support from those who could have helped when it needed help the most, including the Congress, OMB and the organized thrift industry.

(**Current congressional consideration** of legislation to restrict brokered deposits and direct investments highlights two of the areas most responsible for FSLIC's worsening insolvency.)

2) Given the prevalent notion in the financial services industry at the time that the deregulation of liabilities was absolutely tamper-proof, the phenomenon of easily accessible money "available at market", from money brokers who had **no stake** in the current or future health of the federal deposit insurance system, skyrocketed.

These funds could be instantaneously accessed by thrifts and were all too often "invested" in projects which were, as it turns out, doomed to fail. Often the projects were poorly underwritten and sometimes no underwriting was done at all.

3) Institutions which followed such fast deposit growth strategies normally had no real (tangible) net worth, which meant they had little or nothing to lose, except the FSLIC's money. The minimum regulatory net worth requirement had been reduced from 5% to 3% (from 1981 to early 1983) and some so-called "regulatory accounting" devices (including 5-year averaging, 20-year phase-in, loan loss deferral treatment and appraised equity capital) had made net worth requirements relatively meaningless anyway, thus grossly distorting financial reporting and causing perverse incentives to grow excessively and gamble the store.

4) There was a rush of new entrants into the industry, many of whom were real estate entrepreneurs and developers who saw in thrift deregulation (especially at the "state-charter" level) the opportunity to make a killing on the upside, with little or no downside risk. "Heads I win, tails the FSLIC loses." Many either were not aware of, or more likely ignored, the fiduciary responsibilities they had to their depositors (other people's money) and to the government; some were simply incompetent; still others were just out-and-out crooks who saw their thrift charters as a license to loot the enterprise.

5) Some managements that had been caught in the "spread" debacle of 1981 and 1982, which had sapped their institutions' capital, grabbed onto the fashionable notion that to restructure their thrift portfolios, which was not unimportant, they would have to "grow out of their problem." To make that problem relatively small, they chose to grow fast -- taking in vast sums of instantly accessible brokered funds and "investing" the monies in what they apparently

hoped would turn out to be "earning assets." This strategy was **already** producing a different result -- bad assets. (Pages 1-10 highlight the consequences of this fast "grow out of your problem" strategy relying heavily on brokered deposits.)

I assumed the chairmanship of the Federal Home Loan Bank Board on May 1, 1983, only several days after the Bank Board had adopted final regulations to implement the intent of the Garn-St Germain Act.

Within four months of assuming my new position, the FSLIC staff was beginning to express real concern to me that our former "spread" cases were turning quickly into bad asset cases.

I discussed this situation with my colleague, Chairman Bill Isaac of the FDIC. We decided to prepare an Advance Notice Of Rulemaking which was issued soon thereafter.

I became alarmed by the fast-moving turn in events and testified before the House Banking Committee on October 7, 1983, about my fears regarding the brokered funds phenomenon which I saw as fueling the developing "bad assets" cases.

I was so concerned that I urged the Congress to take up the "whole matter of what federal deposit insurance is and what it ought to be used for in the future." I told the committee I also was troubled at the prospects of "irresponsible growth" and expressed fears concerning how this might "impose an undue risk" On the FSLIC. That testimony came just five months after I assumed office (See Addendum 1, Page 1).

By early January, 1984, The Bank Board and FDIC staffs had worked out a joint proposed regulation which was intended to deal with the deteriorating situation resulting from fast growth in brokered CDs.

The regulatory proposal and its adoption several months later were opposed by many, including some on Wall Street, hundreds of thrift institutions, some in Congress and the Treasury Department.

I believed the brokered deposits issue had immense and potentially catastrophic implications for the future of the FSLIC (See Pages 1-10 of Addendum 1). I said on January 31, 1984, that money broker activities had **already** begun to jeopardize the future of the FSLIC and that "allowing this to happen could either result in destroying (the FSLIC)" or in requiring "massive infusions from the U. S. Treasury, and hence the nation's taxpayers." I said it was important that Congress "recognize the possibility of having to cause an infusion of funds from the Treasury." **That was four and a half years ago.**

These concerns were frankly considered by some to be those of a ridiculous "alarmist." My concerns were dismissed by many as "incredible," and "irresponsible" hype.

Some said we were going after "the wrong target" -- namely brokered funds. They knew, however, that the Bank Board's regulatory apparatus was not capable of monitoring and supervising how much brokered money was being utilized by individual thrift institutions. We had no way of knowing how the monies were to be "invested" -- until months later, often well after transactions had occurred and the dye had been cast for disastrous losses.

Again, the thrift regulatory system had completely inadequate examination and supervision resources. We simply had no way of coping effectively with this "spreading cancer," as I was describing it. Some of the opponents of the brokered funds regulation were familiar with the old argument: "Guns don't kill people, people kill people." They appropriated that message, in a rather disingenuous way, to say: "Brokered funds don't kill institutions, the managements of institutions kill institutions." That, of course, was true. It just didn't tell the whole story. The money brokers took the position that what institutions did with the brokered funds was not the money brokers' responsibility, it was "not their problem."

Today, one of very best FSLIC loss correlations can be found by looking at those institutions which had the highest levels of brokered CDs. The higher the levels of brokered funds generally, the greater the volume of direct equity investments (which were often accounted for as loans) and high-risk land loans and, therefore, the higher the losses to the FSLIC.

When a federal district court and then a federal appeals court decided that our joint Bank Board-FDIC brokered funds regulation exceeded our statutory authority, I asked the Congress for legislation to clarify our statutory authority in order that we might reinstate the regulation. We drafted the needed legislation and sent it to the Hill, but no action was taken.

So it was back to square one.

We then developed another approach -- to limit the flow of deposits into an institution (which the brokered funds regulation also intended) by directly tying deposit growth to an institution's ability to earn on that new growth. That regulation was proposed December 1, 1984 and was adopted at the end of January, 1985. In the first year, 1985, it slowed overall deposit growth in the thrift industry from 20 percent a year to around 8 percent.

I believe that had our brokered funds authority been allowed to stand -- either in court or by remedy of statute -- we would not be facing today's massive thrift system crisis. The brokered funds regulation was certainly restrictive enough to have shut the spigot for a while on a vast source of the "irresponsible" deposit growth which was occurring.

The brokered funds regulation was rather crude, yes, but it would have given us a jump on the problem at the time and would have enabled us to concentrate earlier on producing a "growth regulation" similar to the one we later adopted. By severely restricting this **source of funds**, the brokered funds regulation would have greatly constricted the **flow of funds** into what are now see-through office buildings and other black holes of overbuilt real estate, which have caused the FSLIC such disastrous losses.

With respect to the Bank Board's staffing needs which, to put it mildly, were never met or even seriously addressed by OMB or OPM during my entire tenure -- both in terms of the number of employees we needed and the hiring and salary setting flexibility we needed (See Addendum A) -- several high ranking officials of OMB told me personally in 1985 and 1986 that we were violating the "deregulatory policy" of the Administration by asking for substantial increases in staff at the Bank Board.

They apparently took offense that as Executive Branch officials we would even be pressing the point. One said we didn't seem to understand what "deregulation" meant. Another said we had "gone off the Administration reservation when it comes to the meaning of deregulation" -- in other words we were being somehow disloyal.

In 1985, OMB Director Stockman didn't even bother to respond to a 6 page letter I sent outlining my deep concerns. When the Bank Board sought to transfer our field examination force from federal civil service to the Federal Home Loan Banks in 1985, in order to escape the intransigence of OMB and OPM, we again were strongly opposed by OMB.

Indeed, several weeks before we actually made the transfer (which occurred on July 6, 1985), OMB magnanimously offered 39 -- that's right, 39 -- new examiner slots if we would agree **not** to execute the transfer. You should understand that in the 18 months which followed, as a result of the transfer, we ourselves added 750 professional field examiners, doubling the size of the force (to 1,531 on December 31, 1986).

You may recall that before the transfer we were limited by OPM to paying around $14,000 a year to entry-level examiners. Our examiner turnover rates in some parts of the country were as high as 28 percent a year. The average examiner salary at the time was around $25,000 a year. It was, of course, absurd to conclude that given this state of affairs we could effectively monitor the activities of a fast-growing, deregulated thrift industry whose reported assets had already passed the trillion dollar mark.

What we had was a situation in which new employees which had come through a revolving door at the Bank Board, and were earning minimal salaries by any standard, whatsoever, were being thrust into a situation where they were expected not only to analyze some of the most sophisticated and complex financial matters in the history of finance, but they were supposed to keep tabs on the financial dealings of some of the sharpest financial wizards the thrift and real estate industries had ever seen. With all due respect to the very dedicated examiners who were serving under these conditions back then, these wizards could run circles around some of them, and often did. Some of these wizards, in the employ of unscrupulous thrift entrepreneurs, were able to hide from our examiners what was really going on, and their success rate at the time was awfully good.

Key members of Congress, including then-Chairman Garn, you Mr. Chairman, Chairman St Germain of the House Banking Committee, Chairman Barnard of the House Government Operations Subcommittee and Chairman Boland of the House Appropriations Subcommittee all supported our decision to make the transfer. We were deeply grateful.

I should point out here that we had similar problems obtaining authorization to hire FSLIC staff and support personnel. When things got very tough for us in 1985, we had around a hundred professional staffers (excludes clerical) at the FSLIC earning an average salary in the neighborhood of $35,000 a year. Our difficulties with OMB and OPM along the way were virtually the same as those we experienced with the examiners. As late as the Spring of 1987 our request to OMB for a thousand new FSLIC staff (including support staff) was turned down flat. We were given 400 slots, far less than we asked for and needed to deal with the crisis. Salary levels continued to be set by OPM.

The contrast with the FDIC is dramatic.

To begin, the FDIC has a cast of thousands of well-trained employees to do its work. OMB doesn't determine the FDIC's staffing needs. OPM doesn't set the FDIC's salary levels. As a result, the FDIC makes its own decisions and does what it believes has to be done. The FDIC has a "salary compaction problem". Would to God we could have had the luxury of such a" problem."

The FDIC operates, under law, as a "mixed government corporation." The Bank Board/FSLIC does not. Hence the control of OMB and OPM over us.

In early 1984, when we recognized that trying to get OMB's help would be the same as banging our heads against the wall, we included in our comprehensive legislative package the kind of relief we believed we really needed. We proposed, and provided the necessary statutory language to the Congress, to make the Bank Board/FSLIC a "mixed government corporation." This would have enabled us to move much sooner to obtain the examiner and FSLIC staffing help we needed. But, it wasn't meant to be.

Still, I'm very proud to say that, in spite of OMB's intransigence, we effected the examiner transfer in mid-1985 and that we pushed awfully hard to get the field examiner force doubled in 18 months, no small assignment. And, I'm also proud to say that from the Spring of 1984 until I left office, we more than tripled the number of professional (not clerical) supervisory personnel in the Federal Home Loan Banks, from 125 to some 500.

We also effected the transfer of our Office of Examinations and Supervision from civil service to the Federal Home Loan Banks, again to escape the clutches of OMB and OPM.

The Bank Board sent to Congress legislative initiatives (recommended statutory changes) each year of my tenure as Chairman to strengthen our hand in dealing with the immense challenges we faced. They included supervisory and enforcement enhancements so that we could speed up, and make more effective, our actions to deal with problem managements and problem institutions, and thereby save money for the FSLIC, in the short and long term. And, each year, lobbyists from the organized thrift industry had them killed. They whispered that we "really didn't need the legislation," or that "there weren't any real problems, certainly not major ones, and that the regulators were merely engaging in perhaps understandable but, in reality,'overzealous hype and exaggeration -- not to worry.'"

More recent examples of the effects of lobbying by powerful lobbyists from the "organized" industry are everywhere. They righteously proclaimed that the Bank Board was "greatly exaggerating" FSLIC losses when I first asked Congress for recapitalization of the thrift insurance fund in October, 1985. They did it again throughout 1986 and yes, yet again, in 1987 when we sought thrift industry recapitalization of the insurance fund. **We "exaggerated."** Lobbyists from the organized thrift industry used this tactic to a fare-thee-well in killing legislation.

Moreover, the lobbying by some from the organized thrift industry was so dazzling in its footwork and so overpowering in its strength and effectiveness that it was sometimes difficult at first to tell whether the purpose of alternate legislation they sought was to protect savings and loan **depositors**, or to protect savings and loan **operators** running massively insolvent institutions from being shut down. It soon became apparent, however, what they were about. If I seem angry, it's because it looks like the taxpayers -- something I warned about many, many times beginning more than four and a half years ago -- are now going to get stuck with most of the bill, and an enormous one at that. The delays these tactics caused now put the future of the thrift system in great jeopardy. What truly self-inflicted damage!

It also is fair to say that nearly all of the regulatory initiatives we took to bring about industry safety and soundness, and to protect the FSLIC, were opposed by the organized thrift industry when the regulations were proposed. Many sectors of the organized thrift industry strongly opposed virtually every regulation we either proposed or thereafter adopted. Some of these sectors went to considerable lengths on occasion to bring strong back-door political pressure on the Bank Board.

The pressure also was intense when the Treasury Department, under then-Secretary Donald T. Reagan, tried very hard to get us not to propose, or adopt, the Brokered Funds regulation (January-March 1984).

The pressure was intense when we proposed and then adopted the so-called "Growth" regulation and the "Direct Investment" regulation (December 1984-January 1985). Indeed, more than half the members of the House of Representatives signed a Resolution whose purpose was to delay, and yes derail, the Bank Board's Direct Investment regulation. I was told privately by very high ranking members of the organized thrift industry that by proposing these regulations my future career in the thrift industry would be hurt badly, maybe even ruined. I responded that if I had to be the "sonofabitch" to propose them, then "so be it," but that they **would be proposed**. The pressure from the organized industry against adoption of the Growth regulation was fierce. It was outdone only by opposition to the Direct Investment regulation. In both cases, some members of Congress weighed in strongly against the regulations, at the behest of constituents.

The pressure from various quarters in the industry to prevent the Bank Board from re-adopting the Direct Investment regulation (December 1987-February 1987) also was even more intense. We prevailed, **and an even stronger** (equity risk) **regulation was adopted**, linking, for the first time, the volumes of direct investments and high risk land loans which can be made, to **tangible capital** levels. This regulation was excoriated by the organizated thrift industry.

Incidently, the Direct Investment regulation was battled fiercely from the Spring 1984 on not only by the organized industry but also by state savings and loan commissioners from many parts of the country and, most vehemently, by state savings and loan commissioners from Texas and California. In California, however, that changed when William Crawford replaced former state commissioner, Lawrence Taggart. Mr. Crawford vigorously supported the Bank Board's approaches to regulating direct investments and growth. Losses from direct investments and high-risk land loans (which often were in economic substance direct equity investments), again many of which were financed by brokered funds, now litter the FSLIC landscape, from California to Texas to Florida and many points in-between.

The Garn-St Germain Act specifically maintained a three percent (of total assets) effective maximum limit on direct equity investments made by federally-chartered thrifts. Since 1982, when the law was enacted, the Congress has never chosen to raise the limit, and in my mind for quite good reason. On the other hand, the euphoria of thrift deregulation and what it seemed to promise, especially between 1982 and 1984, caused many states to open up their service corporation authorities far beyond the confines of Garn-St Germain.

We at the Bank Board proposed to deal with the fundamental risks this situation would impose on the FSLIC back in 1984. The FSLIC fund had not been fashioned to underwrite the enormous risk we saw resulting from the expanded state investment authorities.

The FSLIC is essentially a "group" insurance plan and we pointed out that no provision had been made for underwriting (through pricing or in any other rational way) the risk of loss to the fund from the diverse and very liberal service corporation (direct investment) authorities conferred on FSLIC-insured but state-chartered thrifts.

The legislation we offered in 1984 and 1985 would have required supplementary contributions to the FSLIC by state-chartered thrifts wishing to engage in more risky activities than those authorized by the Garn-St Germain Act for federally-chartered thrifts. We proposed that when a state-chartered thrift went beyond the operating authorities granted by Garn-St Germain (no more than 3% of assets) that supplementary contributions to the FSLIC should be priced based on the extent to which an institution's activities (such as direct equity investments) went beyond the authorities granted by Congress to federally chartered thrifts. The higher the real net worth of the institution, the lower the supplementary premium contributions to the FSLIC. We did suggest an alternative, that state treasuries could fund the losses resulting from such state thrift operating authorities. No state came forward to claim that alternative. The passage of that legislation, which was submitted by the Bank Board from 1984 onward, was killed by lobbyists for the organized thrift industry.

The fact is, the more liberal the operating authorities which state legislatures have granted their state-chartered thrifts, the worse it has been for the FSLIC. I am not in possession of the data to demonstrate this but it is easily available from the Bank Board. If you check with them, I believe you will find that I am correct. Total up the losses and the levels of insolvency for Significant Supervisory Cases and FSLIC cases now and over the past few years, first for state-chartered and then for federally-chartered institutions. Compare them. I believe the facts will show that for states where liberal state operating authorities prevail for state-chartered thrifts there will be no comparison at all. It has been these state-chartered thrifts, with their far more liberal investment authorities which have dragged the FSLIC deeper and deeper under the quicksand of insolvency. (I would hasten to emphasize that many state-chartered thrift institutions are very well capitalized and are well-managed, prudently run organizations which utilize their state powers wisely and carefully.)

Then ask for data showing what the kinds of profits these same institutions were reporting over the past four years. You will find that a number of these state-chartered thrifts were reporting very high profits -- until they went in the ditch and the chickens came home to roost at the FSLIC. Ask how many have failed. Again, compare how the state-chartered institutions came out against the federals.

Ask how many of the state-chartered thrifts which have failed or are expected to fail, at staggering expense to the FSLIC, have had high levels of brokered funds in portfolio and have recorded unbelievablly high losses from direct investments and land (ADC) loans? Find out how fast they grew? Seek an estimate of losses to the FSLIC which the Bank Board expects as a result.

What you will find will not make for pleasant reading but it will warrant the concerns we were expressing so often during my tenure at the Bank Board when opposition to our many legislative and regulatory initiatives was so great, and when personal accusations that the regulators were "merely engaging in regulatory hype and exaggeration" were able to find a sympathetic audience. Hopefully that's not so anymore.

Each year, from 1984 on, we sought additional enforcement tools through legislation (such as those which are outlined on Pages 14-16 and 44-45 of Addendum 1). These legislative initiatives also were uniformly and summarily killed by lobbyists representing the organized thrift industry. I think we made a very good case for the enforcement enhancements, but the merits weren't the issue. The lobbyists had their orders.

Earlier I made reference to improvements which were made to the Bank Board's so-called regulatory accounting scheme during my tenure at the Bank Board. I can say with no hesitation that one of the most controversial areas of rulemaking at the agency related to the components of regulatory capital and regulatory accounting.

I said to you that when I assumed the chairmanship of the Bank Board there was virtually no tangible capital in the industry as a whole. Two accounting carryovers from the 1970s made things much, much worse. The first was what was called "5-year averaging," in which the previous five years of thrift net worth calculations for an institution were averaged, enabling institutions engaging in fast deposit growth to leverage for deposits off of an artificially reduced net worth requirement. This rendered any meaningful net worth requirement a pure fiction. Leveraging for deposits off of such a fictional base reached 150 to 1.

The second accounting carryover, "20-year phase-in," permitted de novo thrifts (newly chartered thrifts) to take **20 years** -- yes, 20 years -- to reach their **minimum** net worth requirement. To make things worse, 20-year phase-in took place **on top of 5-year averaging**.

These devices were pure accounting poison and, in the face of vigorous opposition from the organized industry, we eliminated 20 year phase-in and began the phase-out of five-year averaging in the Growth regulation we proposed in December, 1984. We eliminated 5-year averaging altogether in 1986 with the regulation to gradually increase minimum thrift capital requirements to six percent of liabilities. The regulation to increase the minimum net worth requirement was vigorously opposed by the organized thrift industry.

In June, 1987, we proposed a regulation intended to assure that the 6 percent minimum net worth requirement would be reached at least by the early to mid 1990s.

And, we adopted a regulation requiring that all FSLIC-insured institutions file their financials using generally-accepted accounting principles (GAAP) effective January 1, 1988.

In addition, we effectively ended the use of loan loss deferral accounting, as of the fall of 1984. And, we put an end to a regulatory accounting practice known as appraised equity capital at the end of 1986.

Indeed, we required the use of tangible capital, for the first time, to determine permissible levels of direct equity investments and high-risk land loans, tying their use to tangible capital requirements. This approach precluded the use of accounting good will in calculating capital for determining equity risk investment eligibility. Each time we strengthened the Board's regulatory capital scheme the organized thrift industry mounted opposition to our efforts.

On June 9, 1987, William L. Robertson, then-Director of the Bank Board's Office of Regulatory Policy, Oversight and Supervision (ORPOS) and William K. Black, then-Deputy Director of the FSLIC, submitted a statement to the Financial Institutions Subcommittee of the House Banking Committee. I asked these gentlemen to address in that testimony the main causes of failures, and particularly the correlation between fraud and insider abuse and such failures. The testimony centered on the most egregious failures in Texas. You will find portions of this Bank Board testimony and its supplementary material in Addendum B.

The Size Of The Bill That Will Need To Be Paid

I have seen estimates recently that range from roughly $30 billion to at least $90 billion. I, myself believed, when I left the Bank Board that the cost would be at least $30 billion. I would not be at all surprised if current operating losses are running at around $7 billion a year, up from $4 billion a year in the Spring of 1987, and $2.2 billion a year in 1986. I don't know what loss writedowns are now running but I would not be surprised if it were at roughly $6 or $7 billion a year. This would mean a $1 billion a month loss. If this were true, and I have no way of knowing whether it is or not, then what I believed when I left office ($30 billion) would have increased to more than $40 billion now. I would have no way of knowing how much more.

The problem is, though that the bill just keeps on rising and rising and rising (as we said it would in 1986 and 1977, See Addendum I and Addendum B), and there appears to be no end in sight. To stop the losses to the FSLIC, the deeply troubled institutions still in operation need to be closed. We could not close them when I was in office because we were running out, or had run out, of money.

Waiting, for example, for the economy of Texas and other parts of the southwest to come back is a losing proposition. The losses are embedded. Operating losses don't come back. Every day of delay only means someone will have to pay a bigger bill.

What Should Be Done To Protect Depositors And Prevent A Recurrence Of This Problem?

Mr. Chairman and members of the Committee, If we truly, genuinely and sincerely want to **protect depositors** and **not savings and loan operators** whose institutions are hopelessly insolvent, then **closing down** these institutions and paying off the depositors is **the way** to do it.

I frankly had the strong feeling before I left the Bank Board that the major thrust of key parts of the so-called FSLIC-recapitalization legislation which were getting very special attention, especially on the House side were intended more to protect savings and loan operators than to protect depositors. **Yet the purpose of deposit insurance, from the beginning, was to protect depositors, not the owners and managements of depository institutions.**

The sooner the institutions in question are closed the better protected the depositors will be -- because most of the depositors I know are taxpayers. Quite simply, the longer these institutions stay open, the more the depositor-taxpayer is going to have to pay in the end for the FSLIC's growing losses, which frankly is such a waste of money.

There may be pragmatic variations on this theme to suit political realities, but I'm simply trying to answer your question straightforwardly.

I've already said that operating losses at these troubled thrifts increased from $2.2 billion to $4 billion in a matter of months when I was at the Bank Board. Again, operating losses don't go away. I don't know when the Texas economy will come back or how many years it will take.

But. I do surmise that things may not have yet hit bottom there yet. What I do know is that the hopelessly insolvent thrifts there are drowning in red ink and they will not come back. In my opinion, it's a pipe-dream to think that these kinds of institutions can be brought back from the aging dead. By definition, these hopelessly insolvent institutions, which were brain dead long ago, are simply **hopeless**. Even if the assets they hold were to theoretically come back in the next few years, everything else remaining constant, they would still -- be massively and hopelessly insolvent as many of these have been for many months if not several years.

As to how to prevent a recurrence of the problem, many of the things we were trying to do at the Bank Board, if taken to their conclusion, are the way to accomplish that goal.

If I had my d'ruthers, here's what you might want to consider:

1. Make the Bank Board/FSLIC a "mixed government corporation." Free the thrift regulator from OMB and OPM. Put the agency on the same footing as the FDIC. Nothing is more important than this.

2. Pass the legislation to enhance the Bank Board's enforcement authority (which has been before the Congress for some time) and which has always been killed by organized thrift industry lobbyists.

3. Make state and federal thrift powers uniform. Or, require state treasuries to pay for losses incurred as a result of liberalized state operating authorities. Or, adopt the legislative approach we were seeking in 1984 and 1985, the "supplemental premium" concept. Try to price the supplemental premium according to the risk of loss.

4. Close institutions which are on their way to insolvency before they reach that point and save the FSLIC money.

5. Don't merge insolvent institutions. The insolvency just gets bigger.

6. Make sure the resolution of FSLIC cases involves real capital contributions from acquirers.

7. Put back the old brokered deposits limit which was no more than 5% of deposits.

8. End the old thrift regulatory accounting practices for good. We did so, but the organized thrift industry will strongly urge backsliding.

9. Rely on real capital (tangible capital) and not good will as the regulatory capital standard of the future.

10. Press the regulators to reach a minimum 6% capital requirement as expeditiously as possible. Achieving it in the next century, which is now the apparent time frame. This is just too long.

11. Require that thrift institutions either earn their growth or they don't grow. Institutions should not be able to grow unless they have the real capital necessary to support that growth.

12. Require more real capital for institutions that follow a riskier strategy and perhaps less for those within very minimal risk. Capital is essential in order to end incentives to take excessive risks.

13. Use the classification of assets regulation to ensure that reported capital is real.

14. End the restrictions contained in CEBA that hamper the Bank Board's utilization of the classification of assets regulation and appraisals, and that overstate capital.

15. Further restrict direct equity investments by putting absolute limits on them. National Banks are prohibited by law from making any direct equity investments. I had to make compromises. The limits should be tied to a percentage of the tangible net worth on an institution's books.

16. Require adequate underwriting and reserves for junk bonds.

17. Beware of off balance sheet, novel financial instruments which Wall Street is pushing at failing thrift institutions to "protect against" interest rate risk. The instraments themselves may end up being much more risky unless extreme caution is exercized at all times.

18. Remove thrift industry influence over the machinery of regulation and supervision of federally insured institutions.

19. Remove statutory provisions which have long been read by the thrift industry as requiring the Bank Board to promote the interests of the industry.

20. Clarify the mission of deposit insurance. Assure that its only mission is to protect depositors (who are taxpayers), and not to protect management or shareholders. Nor is the purpose of deposit insurance to protect speculative investments of any kind. Its one and only purpose is to protect depositors.

OTHER COMMENTS

During the period I served as Chairman of the Federal Home Loan Bank Board we faced many challenges. I am satisfied that we met those challenges as best we could with the resources we had. We tried very hard to talk straight with you in the Congress and with the men and women of the thrift industry.

We didn't do some things right, of course. We made mistakes. But under the circumstances, severely understaffed as we were -- with a regulatory apparatus which was unprepared for, and simply not equipped to deal with, the massive changes which thrift deregulation brought -- we did fairly well, I think.

I think we tried to be straight with everyone about what we saw as real problems for the thrift system, both in the short and long term. We really didn't pull any punches when it came to "telling it like it is." We laid our cards out on the table for all to see. And we misled no one about our deep concerns, and yes our fears.

We took strong positions because we felt the times deserved strong positions. We took regulatory actions which were very unpopular with the industry we regulated. On the other hand, the only way we could have made most of the people in the "organized" thrift industry happy would have been to do **little or nothing**. If we were to meet our responsibilities to the public, that was really not a choice at all.

If we had chosen to say far less "in public" about the impending threat to the FSLIC, especially earlier on in my tenure -- if we had been more willing the sweep the problem under the rug, especially with the Congress -- we would have had far less grief from many in the organized thrift industry.

Unfortunately, many of the things we were saying we were so concerned about have turned out to be right.

We saw our job as that of protecting the FSLIC and the taxpayers. But, surely we couldn't do it alone. It took other parties too: the thrift industry, the Administration and, yes, the Congress.

As it turns out, all parties were deficient. That's why we have the problem today. And, without bold and expeditious action on the part of Congress and the Executive Branch, the problem will only deteriorate further -- and become an even heavier burden on the nation's taxpayers later on.

Please indulge me when I say that the regulator is the creation of Congress, and in many ways is the surrogate of Congress. Congress is the most important regulator of all. The regulator acts, and can only act, under the rules -- the statutes -- the Congress makes. With all due respect to you members of Congress, we could have really used your help back in 1984 and 1985 and 1986 and 1987 with some statutory changes and other measures which we asked for and which we needed very badly -- but didn't get.

We weren't alone in this regard. My colleagues at the Federal Reserve, the FDIC, and the Comptroller of the Currency didn't get their legislation either.

The regulator needs the necessary tools to do his or her job. But, there's a basic problem. The organized thrift industry has far too much clout on the Hill. Too often that means the regulator gets rolled and the lobbyist ends up calling too many of the shots. Virtually all of our legislative proposals were opposed, and killed, by the organized thrift industry.

As you look out into the future, make sure you get good regulators -- people who are serious about their responsibilities to the public and the taxpayers and who won't try to win popularity contests with those they regulate.

Give them all the help you possibly can. Back them to the hilt. Give them everything they need to do their jobs. Then, let them do their jobs. And, by all means, do all you can to insulate them from political pressure and political interference of any kind.

Thank you very much

ADDENDUM 1

Edwin J. Gray served as Chairman of the Federal Home Loan Bank Board from May 1, 1983 to June 30, 1987.

What follows are excerpts of speeches, letters and testimony made by Mr. Gray before various groups and committees of Congress throughout the course of his term in office.

These excerpts demonstrate the deep concerns Mr. Gray had for preserving the safety and soundness of the thrift industry and for the FSLIC during his stewardship.

It was standard practice for Mr. Gray to send copies of the texts of all of his speeches to the individual members of the Senate and House Banking Committees while in office. The speeches -- and testimony submitted by Mr. Gray to the congressional committees -- also were sent on a routine basis to chief executive officers and members of the boards of directors of all FSLIC-insured savings institutions.

Chairman Gray sounded alarms consistently during his tenure in office regarding the gathering storm for the FSLIC, as the excerpts which follow clearly show.

Excerpts Of Letters, Speeches And Congressional Testimony Of Federal Home Loan Bank Board Chairman Edwin J. Gray

1. October 7, 1983
   Testimony, House Banking Committee . . . . .Page 1
   FSLIC Threatened

2. October 17, 1983
   Speech, National Savings and Loan League . . . . .Page 1
   FSLIC Threatened

3. November 9, 1983
   Testimony, House Banking Committee. . . . . .Page 2
   Brokerd Funds, Fast Deposit Growth,
   FSLIC Threatened

4. November 11, 1983
   Speech, American Savings And Loan League . . . . .Page 3
   Risk To FSLIC

5. January 16, 1984
   Statement, FHLB Board Meeting . . . . .Page 3
   Risk To FSLIC

6. January 31, 1984
   Speech, National Council Of Savings
   Institutions . . . . .Page 3
   FSLIC Threatened

7. February 16, 1984
   Speech, American Bankers Association . . . . .Page 6
   FSLIC Threatened

8. March 6, 1984
   Speech, U. S. League of Savings Institutions . . .Page 6
   FSLIC Threatened

9. March 14, 1984
Testimony, House Government Operations
Committee. . . . . .Page 8
FSLIC Threatened

10. March 29, 1984
Testimony, House Appropriations Committee. . . . .Page 10
Shortage of Examiners

11. April 12, 1984
Testimony, Senate Appropriations Committee . . . .Page 11
Examination Resources Inadequate

12. April 25, 1988
Testimony, House Government Operations
Committee. . . . . .Page 12
Empire Of Mesquite, Legislative
Recommendations

13. June 23, 1984
Speech, Virginia League Of
Savings Institutions . . . . .Page 15
FSLIC Threatened, Legislative Changes Needed

14. September 19, 1984
Speech, California League of Savings
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Concern About State Powers, Needed For
Supplemental Insurance Premiums

15. October 8, 1984
Speech, Ohio Savings And Loan League . . . . . . .Page 16
Concern About State Powers, Needed For
Supplemental Insurance Premiums

16. October 22, 1984
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Fast Deposit Growth, FSLIC Threatened

17. October 30, 1984
Speech, U. S. League Of Savings Institutions . . .Pag
State Powers, Fast Deposit Growth, FSLIC
Threatened

18. December 3, 1984
Speech, National Council Of Savings
Institutions . . . . .Pag
"Obsession" To Protect FSLIC, FSLIC
Threatened

19. December 11, 1984
Speech, The Federal Home Loan Bank Of
San Francisco . . . . .Pag
FSLIC Threatened

20. February 20, 1985
Testimony, House Appropriations Committee. . . . .Page
Fast Growth, Bad Assets, Shortage Of
Examination And Supervision Resources

21. February 25, 1985
Speech, California League Of Savings . . . . . . .Page
Condition Of FSLIC, Replenishment Of Fund,
Legislation Needed

22. February 27, 1985
Testimony, House Government Operations
Committee . . . . .Page
State Powers, Direct Investments,
Role Of Examination And Supervision

23. March 12, 1985
Speech, U. S. League Of Savings Institutions . . . Page 23
FSLIC Deterioration, Threat To
Taxpayers, Thrift Deregulation
And Staffing Constraints

24. March 13, 1985
Testimony, Senate Appropriations Committee . . . . Page 25
Examiner Staffing Shortages

25. March 27, 1985
Testimony, Senate Appropriations Committee . . . . Page 26
Direct Investment Regulation, FS&IC
Threatened

26. May 29, 1985
Speech, U. S. League Of Savings Institutions . . . Page 28
Threats To Thrift System, Need For Realism And
Legislation, Threats To FSLIC

27. June 5, 1985
Testimony, Senate Banking Committee. . . . . Page 33
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28. September 19, 1985
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29. October 17, 1985
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30. November 5, 1985
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To And Need For Recapitalization Of FSLIC

31. February 20, 1986
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Severe Staffing Shortage

32. March 5, 1986
Speech, California League Of Savings
Institutions .Page 41
Thrift Deregulation Mentality,
Difficulties With OMB

33. March 13, 1986
Testimony, Senate Banking Committee. . . . . . . .Page 44

34. May 2, 1986
Speech, Boston University. . . . . .Page 45
Thrift Deregulation Mentality,
Need For Recapitalization Of FSLIC

35. May 6, 1986
Speech, National Council Of Savings
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Mentality Of Industry On Deregulation.
Threats To FSLIC

36. May 8, 1986
Testimony, House Banking Committee . . . . .Page 48
Role Of Regulators, FSLIC Threatened,
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37. June 12, 1986
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38. June 18, 1986
Speech, Federal Home Loan Bank Of Pittsburgh . . .Page 50
Threats To FSLIC And Taxpayers.
Need For FSLIC Recapitalization

39. July 30, 1986
Speech, American Bankers Association . . . . .Page 52
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40. September 17, 1986
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41. October 29, 1986
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42. November 11, 1986
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43. November 7, 1986
Speech, U. S. League Of Savings Institutions . . .Page 61
Facing Up To The Stakes For Survival Of The
Thrift System

44. December 2, 1986
Speech, U. S. League Of Savings Institutions . . .Page 63
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Thrift System Will Not Automatically Endure

45. December 18, 1986
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and To Taxpayers.
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46. January 21, 1987
Testimony, Senate Banking Committee. . . . . . . .Page 65
Need For FSLIC Recapitaliztion, Appropriate
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47. January 22, 1987
Testimony, The House Banking Committee. . . . . .Page 66
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48. March 2, 1987
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49. March 2, 1987
Letter to Congressman,
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50. March 2, 1987
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51. March 9, 1987
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52. April 23, 1987
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53. April 24, 1987
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Level Playing Field For FSLIC And FDIC

54. May 14, 1987
Testimony, House Banking Committee . . . . Page 77
Thrift Operating Losses $4 Billion A Year --
And Climbing

55. May 21, 1987
Testimony, Senate Banking Committee. . . . . Page 78
Higher Cost To FSLIC To Ensue.
Danger To Taxpayers

56. June 17, 1987
Testimony, House Banking Committee . . . . Page 79
On Taxpayers Having To Pay

1.

I believe the unrestricted growth of brokered deposits through back-door entry to the federal deposit insurance system will result in **truly far-reaching changes**...at some point in the future.

Mr. Chairman, in light of the rapid growth in third-party money brokering, I would urge that the Congress revisit the whole matter of what federal deposit insurance is and what it ought to be used for in the future. The issues (for the deposit insurance funds) are of such magnitude, I believe they ought to be addressed and resolved in the legislative process.

Nevertheless, the Bank Board and the FDIC have sought to develop a common approach for dealing with the use of brokered insured funds.

We believe the immediate need exists to closely monitor the use of brokered funds to assure that these brokered deposits do not bring about irresponsible growth of the deposit base of a troubled institution and, thereby, impose an undue risk on the federal insurance funds.

From Testimony before the Financial
Institutions Subcommittee of the
House Banking Committee
October 7, 1983

2.

The Federal Home Loan Bank System and its deposit insurance ally, the FSLIC, continue to exist -- and can only continue to exist -- in order to support the mortgage finance function. There is no other reason for their existence.

...There are those in this industry who believe their institutions ought to be allowed to engage in virtually any bank-like activity they wish. They suggest that because its a "free country," why should their institutions continue to operate under asset basket restrictions when banks do not?

It is not inappropriate, therefore, to remind those who now enjoy the wider powers which were accorded their institutions in the legislation (enactment of the Garn-St Germain Act) that what has been achieved was made possible only in a housing finance context.

The Federal Home Loan Bank System is part and parcel of a national housing component and to the extent this fact of life is ignored; to the extent that Congress were ever to come to believe the fundamental purpose of the system had been so compromised that institutions the Home Loan Banks assist no longer strongly emphasized home ownership opportunities, then the system would no longer be able to count on the Congress for its continued support.

The system, itself, would be in jeopardy and the day of its demise would accelerate. As I have said on a number of occasions in recent weeks, and as I want to emphasize again today, you simply cannot have it both ways.

No one needs to remind you that **this industry remains gravely vulnerable to upward interest rate movements.** Nevertheless, failure to heed the lessons of the last several years, in favor of instant expediency on the income statement, can only result in immense problems down the road.

We share the anxieties of many in the Congress and the FDIC about **the wide-open trafficking of brokered funds** by those who have little or no concern for safety and soundness considerations of the deposit insurance funds -- which we have an overriding responsibility to protect. The Bank Board is now working with the FDIC in an effort to fashion a common insurance fund approach to the problems posed by brokered funds.

It is not at all uncommon to trace the irresponsible use of brokered funds to the origins of many FSLIC and FDIC problem cases.

Further, we question philosophically to what extent limited resources of federal deposit insurance should be put **unnecessarily at risk** as a result of money brokering activities.

From A Speech Before The Annual
Meeting Of The National Savings
And Loan League, Maui, Hawaii
October 17, 1983

3.

The Bank Board shares the anxieties of many in Congress, and with the FDIC, about the **wide-open trafficking of brokered funds** by those who have little or no concern for the safety and soundness of the deposit insurance funds --which we at the Bank Board have an overriding responsibility to protect.

It is not at all uncommon to trace the **irresponsible use of brokered funds** to the origins of many FSLIC and FDIC problem cases.

We (FSLIC and FDIC) jointly issued on October 25 (1983) an advance notice of proposed rulemaking...to fashion... regulatory reforms in this area.

I question philosophically to **what extent the limited resources of federal deposit insurance should be put unnecessarily at risk** as a result of money brokering activities.

From Testimony before Subcommittee on General
Oversight and Renegotiation of the House
Banking Committee, November 9, 1983

4.

The Bank Board shares the concern of Congress regarding the open trafficking in brokered funds by **those who have little or no concern for the safety and soundness considerations of the deposit insurance funds.**

Many FSLIC and FDIC problem cases can be traced to the irresponsible use of brokered funds.

We must question philosophically to what extent the limited resources of the federal deposit insurance system should be put unnecessarily at risk as the result of money brokering activities.

From A Speech to American Savings and Loan
League, Albuquerque,New Mexico
November 11, 1983

5.

The Board has seen case after case where failing institutions have taken in federally-insured brokered funds in very substantial denominations from money brokers who apparently had no interest, whatsoever, in the financial condition of the depository.

The issue we take up today hinges on the appropriateness of an unregulated financial entity...placing the funds without regard to the safety and soundness of a recipient depository institution, and **without regard to the ultimate potential consequences for the federal deposit insurance funds.**

From A Statement by Chairman Gray at FHLBB
Board Meeting on Brokered Deposits in
Washington, January 16, 1984

6.

Today, I want to share with you my very real fears regarding the manner in which this mushrooming, unrestrained -- and, in my view, improper -- activity (money brokering) **may already have begun to jeopardize the future viability of the federal deposit insurance system.**

One of the unintended consequences of raising the deposit insurance limit to $100,000 four years ago is the abuse of the system we are seeing today.

Gradually, as third-party money brokerage has proliferated in giant volume leaps, **the nature of many of our toughest cases has now changed to investments in bad assets.** We are increasingly finding that this is occurring because very large sums of money come into an institution from the money broker and they are invested rapidly in what turns out to be -- in all too many cases -- very risky investments. **The only way the federal regulatory agencies could possibly keep up with that (situation)...would be to place an examiner or supervisory official at every institution to oversee and monitor the rapidity of transactions based on the easiest conceivable access to money.**

All too often now, and in a growing crescendo of cases where a range of big transactions is occurring, **the regulator discovers the consequences of such actions within a matter of months, but by then it's too late.** By then, the pieces which are left from the failure of the institution are dropped on the doorstep of the FSLIC...

What may have been a healthy institution some months ago has all too quickly become a very costly problem for the deposit insurance funds to mop up. I could cite a litany of horror stories which have been turned over to the FSLIC in recent weeks. **All of them are substantially attributable to the use of easy money received from the money brokers.** Worst of all, the FSLIC problem list keeps growing.

This is like a **spreading cancer on the federal deposit insurance system.**

The easy access to money broker-supplied funds through the instantaneous transaction, and the growing magnitude of consequences which are ensuing for the federal deposit insurance agencies, simply do not justify the claims which are being made in the name of money brokering...if one assumes, as I do that there is supreme virtue in protecting the safety and soundness of the federal deposit insurance system.

It must be recognized that today, not out into the future, but today -- a substantial part of the $7 billion in reserves of the FSLIC will be required to pay for liquidations and costly assisted mergers which we can foresee, or can expect down the pike in 1984 alone, most of them as a consequence of the brokered money phenomenon.

Does it make any sense...to expect these (relatively) tiny insurance funds to underwrite the vastness, yes the enormity, of risk posed by such (deposit) growth in the future?

In my view, allowing this to happen could either result ultimately in destroying the funds themselves, or by threatening to exhaust the resources of the insurance funds sooner or later, **the situation would require substantial infusions of funds from the U. S. Treasury, and hence the nation's taxpayers.**

It is difficult for me to understand the so-called "serious reservations" of some, given the serious impact I believe this will have on the deposit insurance system in the future, if we fail to rein in, very substantially, the unfettered (deposit) growth we are witnessing.

At the end of September the ratio of FSLIC reserves to deposits at FSLIC-insured institutions had dropped to 1.1 percent. This reserve level has deteriorated steadily during the past decade. Given the nature of the problems the FSLIC is now facing...there is no reason to expect any strengthening of this reserves-to-deposits ratio in the foreseeable future unless the problem is addressed head on, and soon.

The Bank Board's projections demonstrate that were the present rate of growth (in brokered deposits) to continue, the current ratio would likely drop somewhat below 1 percent in the next several years. This, in turn, would surely prompt imposition of - additional premium assessments on FSLIC-insured institutions in order to merely bring the ratio back to what it is today (January, 1984) -- which already is well below historic levels. This would be very costly to our savings institutions.

I can find no public policy virtue in permitting this situation to continue in the future to further exacerbate -- yes further jeopardize -- the safety and soundness of the federal deposit insurance system.

It is important that (savings) institutions fully understand how inaction or failure to come to grips with the implications of the (deposit growth) issue could jeopardize the future viability of the deposit insurance system.

It is important for the Congress to recognize the possibility of having to cause an infusion of funds from the Treasury to back the credibility of the deposit insurance system, at some point down the road, should the Bank Board and the FDIC fail to deal with this issue.

Surely, extending the risk of federal deposit insurance well beyond the confines of depository institutions and into the infinite recesses of our financial system -- through the kind and volume of money brokerage activities we would envision without firm, corrective action -- **could result in such Treasury (taxpayer) infusions in the future.** Finally, and

most important of all, the American public should understand the stakes involved...

From A Speech to Lawyers Seminar, National
Council Of Savings Institutions,
Washington D. C.
January 31, 1984

7.

There are some in the money brokerage community who would have you believe that third-party money brokering poses little or no danger to the federal deposit insurance system.

In my view, it would be wrong -- dead wrong -- to play chicken with the future viability of the federal deposit insurance system simply because those who have no stake whatsoever in the future of the system choose to conveniently articulate self-serving arguments...in order to justify the continuation (of) today's federally-insured money brokering.

Without firm, decisive and expeditious remedial action, I believe **the future viability of the federal deposit insurance system could be gravely threatened -- so much so that only massive infusions from the Treasury, and hence the taxpayers** -- could well be required to support the deposit insurance function which, heretofore, has been funded by premiums paid by depository institutions themselves.

From A Speech Before The Banking Leadership
Conference of the American Bankers
Association, Washington D. C.
February 16, 1984

8.

I believe third-party, federally-guaranteed, and yes, federally-subsidized **money broker activities are a spreading cancer on the federal deposit insurance system.**

In all honesty, I would be derelict in my solemn duty to head, manage and protect the FSLIC, if I failed to call to your attention the **alarming** manner in which third-party money brokering activities are **today laying the groundwork for the ultimate demise of "savings" institutions** as we have known them, **and for the federal deposit insurance system as we have known it for a half a century.**

I am frankly **shocked** by the passivity, indeed misunderstanding, as to **the high stakes implications** for the future of savings institutions, which seems to be the case of many in the (savings institutions) industry as we approach the money broker issue.- Feeding this infant lion may seem simple and innocent today. As he grows, he becomes more dangerous.

Chances are very good he will consume you for dinner before very long.

It is time you wake up to the stakes this issue poses for your future. **If you don't,** if you fail to push aside the trees so you can see the forest beyond, then I fear deeply for the future of the industry. If you are intent on sacrificing the long-term view for short-term expediency, **you will have only yourselves to blame, in the end.**

This activity is literally out of control. It is growing by leaps and bounds. The fact is, the federal deposit insurance system was never meant to underwrite this huge new (deposit growth) risk, this double whammy on the FSLIC and FDIC. These funds were never fashioned through the (insurance) premium structure to bear such a skyrocketing risk burden.

The lightning fast growth of third-party, federally-guaranteed brokered funds activity we are witnessing **can only exacerbate the problems of the FSLIC.** Unfortunately, we're seeing a growing crescendo of cases in which what was only some months ago a healthy institution has become a failing institution. The ease of access to brokered money not only has brought about incredibly fast deposit-growth...but this growth, just as quickly, has transformed itself into risky investments which, in turn, have produced bad assets.

In fact, the nature of our toughest cases has now changed to investments in bad assets. Because of the speed by which these transactions take place (fueled by brokered deposits), and because we're talking about the transformation of what were healthy institutions into very expensive failures -- particularly because of the new bad asset problems -- we are encountering **very costly difficulties. These very expensive failures are eating into the FSLIC's reserves,** and further exacerbating the FSLIC's reserves-to-deposits ratios.

These brokered funds-related problems are occurring so fast that **by the time our examiners discover such problems, it is simply too late.** The FSLIC is left holding the bag.

In truth, you don't need many of these kinds of problems...to very seriously endanger the insurance fund.

Indeed, from my everyday exposure to the new problems coming on line, I have reason to say that money broker activities **already have begun to jeopardize the federal deposit insurance system.** With what we're now seeing, added to the enormous new risk these brokered funds activities are piling onto the deposit insurance system, **it is not only conceivable, but in my view very possible, that at some point in the future, massive infusions from the U. S. Treasury -- and hence the American taxpayers -- may well be necessary to shore up the system.**

I shudder to think of that possible eventuality and the effect on your credibility as institutions to transact business with the public. The point is, we are looking at an emerging very serious problem already for the deposit insurance fund. **The stakes for** the industry and **the federal deposit insurance system are very great.** Unless the...enormity of new risk federally-insured brokered funds activities pose for the safety and soundness of the federal deposit insurance system are dealt with decisively and soon, **I fear for the future of the nation's depository institutions system.**

From A Speech to Annual Legislative
Conference, U. S. League of Savings
Institutions, Washington D. C.,
March 6, 1984

9.

In only two years, brokered deposits at FSLIC-insured institutions have undergone an eightfold increase -- from $3.5 billion at the end of 1981 to nearly $30 billion at the end of 1983. Indeed, such brokered deposits at savings institutions tripled last year alone.

It is the ease of access, instantaneous access, to huge amounts of federally-insured brokered funds by institutions which then funnel such funds into very risky, hurry-up investments which causes **me the gravest possible concern,** given my solemn responsibility under law, at the direction of the Congress, to protect the safety and soundness of the FSLIC.

Based on problem cases that we can now foresee in 1984 alone, not to mention those which may emerge in due course, cases which in large part correlate very closely with high levels of federally-insured brokered funds, we can now expect a substantial level of losses to FSLIC reserves this year. These losses will be due, in large part, to **bad assets,** resulting from poor and risky loans made by institutions which choose to engage in **lightning-fast deposit growth,** made possible by **instantaneous access to brokered money.**

Given the state of the industry in general today and given the deteriorating ratio of FSLIC reserves to deposits ..we who manage the FSLIC are **deeply troubled** by the impact of such brokered funds activities on the thrift industry's insurance system.

When you consider...the new wave of federally-insured money brokerage activity...when you consider the mushrooming growth...when you extrapolate how this may very well pile onto the federal deposit insurance system incredible new risks in the years to come, and when you recognize it doesn't take too many failures of institutions to very seriously endanger the viability of **the federal deposit insurance system, then I hope you can understand why I am so concerned** about the unintended, and indeed **alarming, role federally insured money** brokering is now playing in our **problem cases.**

I am convinced that one way or another the incredible growth in federally-insured money brokering must be very **substantially reined in,** and **very soon,** if we are to protect **the future safety and soundness of the federal deposit insurance system.**

The impetus to make bad loans, we have found, derives from the incredibly easy access to virtually unlimited amounts of insured funds from money brokers. The ease and speed with which a savings institution may obtain vast sums of money from deposit brokers permit these institutions to embark on ill-conceived plans of expansion -- making very large loans very quickly, often too quickly to be carefully underwritten. Brokered deposits are also seen by managers of troubled institutions as the way to fund their last gasp gamble before the regulator can step in.

The list of horror stories resulting from the misuse of brokered funds by desperate financial institutions is growing as the weeks and months go on.

The lightning speed with which an insured institution can obtain large sums of money from deposit brokers invites grand schemes of expansion. Managers capable of adequately directing the affairs of a small institution find the pace of expansion too difficult to control, and the end result is not only an expansion of the liabilities of an institution, but also an expansion of the liabilities of the FSLIC.

What is most striking...is just **how close a correlation** we have found between the use of brokered funds and the likelihood that a thrift institution is heading for serious trouble. By the end of 1983, brokered funds accounted for only 4 percent of all savings and loan liabilities, but they are closely associated with **almost half** the supervisory cases now coming through the door.

The only way the federal regulatory agencies could possibly prevent such rapidly moving (brokered funds into immediate loans and investments) transactions would be to **place an examiner or supervisory official at every institution** to **oversee and monitor the transactions.** Thus without some alternative that directly addresses the proliferation of money brokerage activities, healthy savings institutions will continue to have unlimited access to brokered funds and plunge into risky **and devastating investments before detection** during the examining cycle.

For 1984, we project that a **substantial** part of the $6.3 billion FSLIC fund will have to be spent to cover liquidations **and supervisory mergers.** This projection did **not** include **additional cases** which have recently come to light.

In my view, allowing this to happen (unfettered brokered funds growth), could either result in **ultimately in destroying the federal deposit insurance funds,** or in threatening to so exhaust the resources of the insurance funds that **substantial infusions of monies from the U. S. Treasury, and hence the nation's taxpayers,** would be required to shore them up.

From Testimony Before The Subcommittee On
Commerce, Consumer and Monetary Affairs
Of Committee On Government Operations,
House of Representatives, Washington,s
March 14, 1984

10.

We are facing a potentially **acute shortage of examiners.** Our major concern is **a growing asset quality problem,** compounded in part by the injection of brokered savings into the financial system. Simply put, **a large number of institutions have taken in more funds than can be safely employed in prudent lending,** resulting in **growth which is almost uncontrollable.** Our computer-assisted examination process will permit us to track an institution's financial condition more effectively. However, it was not intended to permit examiners to review the quality of an association's loans. That has to be done on-site at the institution by both examiners and Board appraisers. **Increased examination staffing, including field examiners and appraisal specialists, are needed to monitor and address the risks which these severe asset quality problems create for the insurance fund.**

A number of states have enacted new nontraditional powers for state-chartered institutions. Thus, we are facing not only rapid growth but an increasingly complex environment in which funds are being deployed in unaccustomed ways. On-site examination is essential to assure prudent use of these new authorities.

One important reason **the Board needs to add field examiners** is to conduct such on-site examination for state-chartered institutions insured by the FSLIC. **We also are seriously understaffed** with respect to examinations in data processing operations in institutions.

Problem caseload of both the FSLIC and the Office of Examinations and Supervision remained at a very high level during 1983. ...The volume of assets and complexity represented in 1983 cases increased significantly.

That is most alarming. FSLIC expects its caseload over the next several years to be made up of institutions suffering from loan losses due to unsafe and unsound lending practices. **Detection of asset quality problems...requires frequent on-site examinations... The alarming asset quality problems of many institutions now coming to light render our currently authorized level of examiner resources inadequate.**

From Testimony Before The House Subcommittee
On Appropriations, Subcommittee On
Independent Agencies, Washington D. C.
March 29, 1984

11.

The asset quality problems of 1983, and through the present, are larger and more severe than those the FSLIC faced in the late 1960s because of the rapid growth made possible by deregulation of liabilities and, in that connection, by the availability of insured brokered deposits.

Aggressive state actions to permit state-chartered thrifts to engage in a wide array of nontraditional activities necessarily creates a much more volatile risk-exposure climate for the FSLIC, and thrifts which use their powers unwisely have been able to access and use brokered funds to grow from small problems into large ones virtually overnight.

There is a significant correlation between associations using brokered funds and those which are supervisory problems.

The **alarming** asset quality problems of many institutions now coming to light render our currently authorized level of examiner resources **inadequate.** The Board **must (be able to) increase its examination staffing** to address the increased risk exposure resulting from rapid growth in an increasingly complex environment.

I believe that states which enlarge thrift powers for state-chartered institutions beyond those permitted federally-chartered thrifts, or which are chartering more thrifts, should proportionally increase their own regulatory and examination efforts.

From Testimony Before The Senate Committee
On Appropriations, Subcommittee On
HUD-Independent Agencies, Washinton
April 12, 1984

The temptation to make up for past losses leads to high risk speculation. Indeed, in cases like Empire (Empire Savings and Loan Association, Mesquite, Texas), the easy availability of cash was used to finance a gigantic fraud, at the expense of the FSLIC.

This new environment, combined with rapidly increasing deregulation of permissable investments by more and more states, now seems destined to lead to **higher risk and increased losses** to **an insurance-of-accounts structure which was fashioned for institutions making large mortgage loans on homes.**

In my March 21, 1984 testimony before the Senate Banking Committee, I **recommended and I wish to recommend here again, that legislation be developed to limit the asset and liability powers of state-chartered thrift institutions** in such a way that the Bank Board (FSLIC) may have sufficient discretion to ensure the safe and sound use of any new asset authorities. I specifically proposed, as a concept, deserving the highest legislative priority, granting the Bank Board plenary and exclusive authority to (1) waive restrictions where use of new asset and liability powers is consistent with a sound and profitable principal home lending commitment (such as that provided for under the Garn-St Germain Depository Institutions Act of 1982) and (2) providing the Bank Board broad discretion to require that thrift institutions undertaking highly risky activities make separate and additional contributions to the FSLIC, commensurate with the additional risks the new activities may be deemed to impose on the insurance fund.

Action to reconcile the current deposit insurance structure with the escalating challenges of deregulation is **crucial** to the **continued viability of the FSLIC fund.**

This agency must be able to take swift and immediate remedial action at the first sign of trouble. However, our most potent tool in this regard does not give us clear authority to act in many cases.

For example, (it) requires the agency to find that a violation of regulations or unsafe or unsound practice is likely to cause insolvency or substantial dissipation of assets or earnings of the institution, or to seriously weaken its financial condition.

While the October, 1982 examination of Empire found violations of regulations and practices that were clearly unsafe and unsound, Empire,at least on paper, did not appear to be heading toward insolvency. Instead, its earnings and assets appeared to be growing.

A sustainable Temporary Cease-and-Desist Order would have had to prove that the missing or inadequate appraisal reports, the missing documentation to support construction loan disbursements, and the speculative real estate lending practices were leading Empire to substantial dissipation of assets or a serious weakening of its financial condition. Unfortunately, appraisals sometimes take months to obtain.

Our authority to combat these practices would be significantly strengthened if our Cease-and-Desist authority were clarified by statutory amendment. ...This authority should clearly provide that whenever an institution's books and records are so incomplete or inaccurate that this agency is unable to determine the financial condition of the institution, that **this showing alone is sufficient for issuing a temporary order requiring the cessation of any practices the Board may deem appropriate.**

Our authority to stop unsafe and unsound practices needs to be further clarified by statute. In pursuing a Cease-and-Desist action based on unsafe and unsound practices, the agency should not be required to show substantial dissipation of assets.

We recommend a further statutory amendment defining "unsafe and unsound" practices to be any action or omission which, in the sole discretion of the Board, is determined to be **contrary to generally accepted standards of prudent operation,** the possible consequence (being) abnormal risk to an insured institution or its subsidiary, to the accountholders, or to the FSLIC. **The likelihood of financial loss to the institution should not be a prerequisite to a finding that a practice is unsafe or unsound, because by the time the financial loss can be shown, it may be too late.**

This type of statutory amendment would remove any doubt that unsafe and unsound practices are not restricted to those that have a direct adverse impact on an institution's financial soundness. This authority would allow the Bank Board **to halt an unsafe and unsound practice** while allowing continued prudent operations and an opportunity for corrective action by the insured institution.

Our authority to **remove** directors, officers, employees, agents or other persons participating in the conduct of affairs of an insured institution **should also be strengthened.** For example, **breach of professional as well as fiduciary duties should be included as grounds for removal.** This would have made clear that Empire's appraisers could have been prohibited from continuing in the land swap scheme participated in by the institution if the remaining statutory grounds could have been established.

In addition, this agency should be required to show only the **probability** of financial loss -- **not actual substantial financial loss** -- so that corrective actions can be taken promptly.

The Board also should be given continuing jurisdiction over persons who resign from an institution in order to avoid a prohibition action (in order to) prevent an individual from resigning from a savings and loan institution only to move to a commercial bank and cause the same financial harm to that institution.

For more serious problems involving persons with little or no respect for regulatory direction, **immediate access to the federal courts is a necessity. The Bank Board, on behalf of the FSLIC, should be explicitly authorized by law to go directly to federal court to obtain a temporary restraining order, and then an injunction, for any violation of a statute, rule, regulation or other order.** This would increase the speed and effectiveness of our attempts to control institutions that are violating the law.

Strengthening the Board's authority to deny a **change in control** would be an important addition, since a number of acquisitions of control have been followed by dramatic changes historical operating procedures, high growth and high risk,. For example, the Change in Control Act should be amended to require the acquiring entity's future business plans to be consistent with the safe and sound operation of the institution and not otherwise detrimental to the insurance risk of the FSLIC. These same grounds for denial should also be applied to holding company acquisitions.

Certain definitions in both the Change of Control Act and in the Holding Company Act should be clarified to **insure that a group of individuals acting in concert to gain effective control of an institution do not escape scrutiny.**

Enforcement and penalty provisions should be **added** to the Change Of Control Act, and the Bank Board should be given **explicit authority** to condition any approval under that Act, backed up by specific Cease-and-Desist authority. **These amendments would strengthen this agency's ability to stop unscrupulous individuals before they can do significant damage to an insured institution.**

Further, the Board should be given the authority to order recession and restitution for violations of the Holding Company Act as a method to insure that this law is respected.

From Testimony Before The House Committee
On Government Operations, Subcommittee
On Commerce, Consumer and Monetary
Affairs, Washington, April 25, 1984

13.

The losses we are seeing, and can reasonably foresee down the line, are now causing a steady and significant deterioration in the insurance fund's level. Today, in the new (deregulated S&L operating) environment, **we lack enforcement tools,** the kind which we need to promptly take action in cases where we believe an institution may be acting in an unsafe and unsound manner. **By the time we can prove dissipation of assets, the institution may have turned itself into a huge loss for your (FSLIC) group insurance fund.**

With our mandate to protect your group insurance fund's resources, **it prompts us to wonder how we can do the job expected of us with our hands tied behind our backs.**

A series of legislative proposals we have brought out have been introduced (in the Senate by Chairman Garn, and in the House by Congressman Wylie of the Banking Committees). We've urged that the industry consider them carefully and in doing so not to have a kind of knee jerk reaction to them.

Frankly, **from our insurance perspective...we find ourselves (as regulators) in a safety and soundness straitjacket.** I've come to the conclusion that the only alternative to this dilemma is greater (legal authority to have) flexibility to deal effectively with potential emerging problem cases which we are seeing in profusion.

From A Speech Before The Virginia League
Of Savings Institutions, Hilton Head,
South Carolina, June 23, 1984

14.

I personally believe that given the more highly speculative nature of new and emerging investment authorities in various states which charter their own thrifts -- and which also require FSLIC insurance -- that a new, supplemental deposit insurance scheme is necessary.

The Bank Board has specifically proposed to the Congress legislation which would require supplementary contributions to the FSLIC by state-chartered thrifts wishing to engage in more risky activities than those permitted (to federally-chartered thrifts) by the Garn-St Germain Act of 1982. Such (premium) contributions would be tied to the degree to which an institution engaged in such activities and would be commensurate with the degree of risk involved. Supplemental premiums also could be keyed on the institution's snapshot net worth.

Such a program would require legislative sanction. Unless and until such approval is forthcoming from the Congress -- and in a manner which truly protects the FSLIC from undue risk -- The Bank Board will have no choice but to consider insurance-related regulatory constraints on direct investment authorities.

From A Speech Before The Annual Convention
Of the California League of Savings
Institutions, Colorado, California
September 19, 1984

15.

We are certainly aware of "states rights" concerns. But, how the (risk to the) FSLIC is managed, and the degree and nature of the risk it can be expected to underwrite, are issues we -- and ultimately the Congress -- are called upon to consider.

While it may be in fashion to assert that FSLIC-insured thrift institutions deserve virtually unlimited freedom to succeed or fail, responsibility dictates a firm recognition that the FSLIC has not been designed to pay, nor does it have the resources to pay, the full costs of such failure.

I believe that given the more highly speculative nature of new and emerging investment authorities in various states which charter their own thrifts -- and which also require FSLIC insurance -- that **a new, supplemental deposit insurance scheme is necessary**.

From A Speech Before The Fall Management
Conference Of The Ohio Savings And
Loan League, Columbus, Ohio
October 8, 1984

16.

I must tell you that I am becoming **more and more concerned** about the heavy focus on rapid deposit and asset growth by too many savings institutions today. This growth-for-growth's-sake mentality, in which pell-mell growth is too often the result, is a strategy which is unhealthy.

We are finding that the institution which wasn't in trouble, or at least wasn't in relatively great trouble, is likely to get into deep trouble all too quickly when this mode of operation is pursued.

We are monitoring such fast-growth operations...for the purpose of detecting and dealing with the early warning signals. Growth-for-growth's-sake...is moving up geometrically (in hundreds of institutions, and **this) gives very substantial reason for concern** because there is virtually no correlation between such growth and even regulatory net worth levels at far too many FSLIC-insured institutions.

In my opinion, **the thrift industry must come to grips with this problem** honestly and expeditiously, just as we intend to do.

We need not look very far down the road to recognize the bleakness of the alternative represented by inaction, and its very heavy consequences for the continued integrity of our thrift institutions system.

From A Speech Before The 67th Annual
Convention, Savings Banks
Association of Massachusetts,
Boca Raton, Florida
October 22, 1984

17.

Under our statutory mandate, we must always side with those considerations which best enable us to protect the safety and soundness of the FSLIC.

Any state which chooses to assume responsibility for chartering and regulating its own thrift institutions **has every right...to insure** the operations of those same state-chartered institutions.

We at the Bank Board have no problem with any operating authorities a state may wish to establish for its own state-chartered institutions -- **if such state is willing to underwrite the risk of those institutions' activities.**
The FSLIC is a federally-established (not state-established) insurance corporation. When state-imposed investment authorities have the effect of placing undue strain on the safety and soundness of the FSLIC, then it is our responsibility to carefully assess how best such strain can be accommodated or limited.

The (asset and deposit) growth trend we're seeing is supported by no real, tangible net worth in the industry as a whole. What we face...is a situation where deposit and asset growth are spiraling upward at a dizzying pace which, all too often, is unrelated to real -- or even regulatory net worth -- and which is not even faintly related to the level or magnitude of reserves on hand at the FSLIC. Indeed, the ratio of effective, usable reserves-to-liabilities at our insured institutions is worsening.

This is a problem you must come to grips with honestly, forthrightly and expeditiously **if you expect your separate (thrift) system to be around for very long.**

Growth must be tied to regulatory net worth in the short term, and to **real capital** over the long haul. In addition, **even relatively risky investment strategies engaged in by healthy institutions ought to be tied to a supplementary risk-related premium such as what which the Bank Board proposed to the Congress in the Spring.**

I haven't relished the prospect of bringing these...issues before you. Nor is it pleasant, or even an overstatement, to say to you **that you would ignore them at your future peril.**

From A Speech Before The Annual Convention
Of the U. S. League Of Savings
Institutions, Washington D. C.
October 30, 1984

16.

I have heard it said, on repeated occasions, that the Bank Board appears to be "obsessed" with protecting the safety and soundness of the FSLIC, and that may not be in the industry's best interests. The fact is, each of us who serves on the Bank Board has taken an oath to uphold the duties of our office. We are required to protect the safety and soundness of the FSLIC -- by law.

I would like to cite some facts and figures.

First, the effective, usable reserves of the FSLIC are **declining,** yearly premium contributions to the fund notwithstanding. Second, the ratio of FSLIC reserves to assets **is continuing to decline.** That ratio is now less than one percent. Third, were present trends to continue, the ratio of FSLIC reserves-to-liabilities in the thrift system would decline to one half of one percent in 1988 -- just four years from now. Fourth, the thrift industry as a whole has no **tangible net worth.** Fifth, in contrast to the fact that the effective, usable reserves of the FSLIC are declining, present asset growth trends in the industry as a whole are **skyrocketing. In view of these facts and trends, one must ask whether such a situation could...be sustained for very long without potential consequences of substantially significant magnitude for the savings and loan system.**

Too many high-priced liabilities are chasing too few good assets. The fact that funds can be accessed immediately in any magnitude...is cause for deep concern. **Our goal is, and must be, prudence, safety and soundness, within the industry and at the FSLIC.**

From A Speech Before The Management Conference
Of The National Council Of Savings
Institutions, San Diego, California
December 3, 1984

19.

The FSLIC **is** today **called** upon **as** never before to underwrite **an expanding** range of **risk**. **Meanwhile**, the effective, usable **reserves** of the FSLIC **are declining** and the ratio of FSLIC **reserves-to-liabilities** it insures **is declining steadily**.

Hence, it is, I **believe**, in the (thrift) industry's own best interest to seek to understand the **overriding importance** of husbanding the relatively scarce resources of the FSLIC. **Negative, knee-jerk reactions to (Bank Board regulatory) initiatives which are sincerely intended to balance the interests of the industry and the risk to the FSLIC serve** no **useful purpose except to perpetuate confusion and misunderstanding.** There needs to be more light and less heat shed on the polemics of our discourse on this critically important matter to the future well-being of the fund and the industry.

Our goal at the Bank Board is, and must be, prudence, safety and soundness -- within the industry and at the FSLIC -- if our (savings and loan) system is to rebuild its overall strength and financial resources in the future.

From A Speech Before The Annual Economic
Conference Of The Federal Home Loan
Bank Of San Francisco, San Francisco,
California, December 11, 1984

20.

With the advent of deregulation...in which some states have granted state-chartered instituions operating authorities which go far beyond the limits of Garn-St Germain, **the ability to underwrite the risk the insurance corporation must bear has become far more difficult.**

As a result, **the strains on the FSLIC's ability to bear the financial burden of increasing losses when insured institutions become hopelessly insolvent are drawing down the book reserves and the effective usable reserves of the fund at a quickening pace.**

Many of the failures and projected failures we are seeing are, and will be, **far more costly** for the FSLIC to resolve. Many are the direct result of investments and poorly underwritten loans which have gone sour. **They translate into bad assets which have been fueled by the rapid growth of high-priced liabilities, instantaneously accessed in the marketplace.**

The main role of supervision and examination in the Bank Board's regulatory process is to achieve safety and soundness, both for the institutions and for the FSLIC. Deregulation makes effective examination and supervision imperative. Yet,

the fact is we have an inadequate number of well-trained examiners in our system to do the job.

Turnover rates within our examiner force are high. Entry level salaries are low, **lower than those for our sister financial agencies.** Attracting and retaining qualified examiners is **difficult.** Often bright young examiners are hired away within several years by thrift institution managers themselves.

Yet, **the function of the examiner in today's far more sophisticated, deregulated financial environment, is more crucial than ever to our job** of spotting problems early enough so that corrective action may be taken by supervisory agents **before problems mount** and ultimately **become very costly disasters** for the FSLIC.

Our field examination force is seriously understaffed and the need for better coordination between examination and supervision is great. **We must have the ability to attract, train and retain more examiners.** Our track record in this regard is not good. We elicit the understanding of this Subcommittee as we seek to deal with this problem and to devise workable solutions.

From Testimony Before The House Committee
On Appropriations, Subcommittee on
HUD-Independent Agencies, Washington,
February 20, 1985

21.

The need to look after, with the greatest of care, the continued viability of the FSLIC, the credibility, adequacy and strength of the FSLIC(means it) ought to be of the very highest priority to the industry as a whole and to the individual savings institutions.

Ladies and gentlemen, things are not the way they might seem to some. It is important that you know that the perception of a roughly six million dollar fund...simply masks a very different reality.

After subtracting the projected costs of resolving a growing caseload of, unfortunately, hopelessly insolvent institutions -- and factoring in the number and projected costs of these kinds of cases, cases which are arriving and are due to arrive on the FSLIC's doorstep in the near and foreseeable future -- the fact is, and will continue to be during the next several years at least, that **the true resources of the fund are, and will be, far less -- yes, far less -- than the declining level of FSLIC book reserves.**

All of our evidence shows that this deteriorating movement is inexorable, absent remedial action. The numbers we see, both in the significantly growing number of cases projected, and in the projected costs to the FSLIC to resolve those cases, has been in recent months, and continues to be, of deep concern to the Bank Board.

As I said to the members of a Congressional committee last week, **the strains on the FSLIC's ability to bear the financial burden of increasing losses when insured institutions become hopelessly insolvent, are drawing down the book reserves, and the effective, usable reserves of the fund at a quickening pace.**

Even the exercise of our full authority to begin replenishing the real reserves of the FSLIC (an additional one-eighth of one percent of deposits special assessment) **would not truly even begin to provide the long-term replenishment necessary** to properly and adequately strengthen the resources of the insurance corporation.

Both houses of the Congress have pledged the full faith and credit of the United States to stand behind the FSLIC so that no depositor can ever suffer the loss of funds placed in insured accounts.

However, we believe that **any set of legislative goals should serve to preclude the possibility of ever resorting to the funds of the United States government, itself -- that is to say, to American taxpayers.**

I believe that **any set of legislative objectives should work to assure that the total cost of FSLIC insurance will always be borne by insured institutions themselves.**

From A Speech Before The Management Conference
Of the California League Of Savings
Institutions, Rancho Mirage,
California, February 25, 1985

22.

Some of the operating authorities in some states go well beyond anything contemplated by the Garn-St Germain Depository Institutions Act of 1982. In California, for example, the legislature granted its own state-chartered thrifts operating powers which permit substantial direct investment authority and the right to allocate up to 100 percent of assets in service corporation activities. **The sole responsibility for protecting the funds of insured accountholders in these state-chartered thrifts has been relegated to a (single) federal agency, the FSLIC.**

We not only support, but we have proposed and will continue to urge the enactment of, legislation to provide for variable premium assessments against institutions which choose to

engage in activities which carry a greater risk of loss to the FSLIC. We do not have the authority to assess variable premiums against institutions relative to the degree or maginitude of risk activity that they choose to engage in.

To fail to study rational alternatives (in the absence of such legislation), and after doing so, to fail to take appropriate measures through the statutorily defined rulemaking process to protect the reserves of the (FSLIC) fund from undue loss, would be both irresponsible on our part and would constitute a dereliction of duty under our mandate as operating head of the FSLIC.

With regard to rapidly growing institutions, supervision alone is not an adequate alternative. Growth at very high rates not only makes it difficult for an institution to locate sound, prudent investments. It also makes it difficult for the Board's staff to examine and supervise institutions in a timely and effective fashion.

Examination lags far behind the acquisition of deposits or the investment of these funds. When rapid growth is not matched with prudent increases in capital, the problems associated with such growth may increase dramatically between examinations. In other words, the damage is done before any supervisory examination is made, and well before the Bank Board can take any corrective action.

The delay between the time an asset is acquired or a deposit is accepted, and the time that those actions are reflected on an institution's reports filed monthly further demonstrates that supervision is not an acceptable alternative to before-the-fact review.

Moreover, once the reports are filed, the Bank Board cannot assume it has accurate information about an institution's financial condition. **Losses on direct investments are often not reflected on the institution's books.**

(Nevertheless) the Bank Board has taken several steps to strengthen its ability to supervise and monitor the activities of savings instituions. These measures include immediate on-site evaluation of any institution exhibiting excessive growth. **Additionally, the Bank Board has (had) introduced legislation...to increase and strengthen its enforcement powers.**

From Testimony Before The House Committee
On Government Operations, Subcommittee
On Commerce, Consumer and Monetary
Affairs, Washington D. C.
February 27, 1985

We are now looking at a mounting caseload at the FSLIC and most of the cases are characterized by bad assets. I am again urging you in the industry to come to grips with, and to deal with, and face up to, the challenges all of us face. The luxury of sheer delay, if any here think it may have existed before, has long since passed.

In this regard, I am convinced that a **legislated** solution to the FSLIC challenge we face -- a solution which emphasizes long-term replenishment and maintenance of adequate reserve levels of the insurance fund -- **is absolutely essential. I believe a legislated solution should include the establishment of a risk premium (on state chartered institutions which utilize operating authorities which exceed the parameters set under the Garn-St Germain Act for federally-chartered institutions)** which more fairly allocates the cost of risk to the FSLIC and takes into account he level or real net worth maintained by an institution.

This is a time for all of us to work together, and pull together, to reach the goal of **long-term replenishment and maintenance of adequate levels of reserves in the FSLIC fund.** You as responsible members of the (U. S.) League, working with the Bank Board, members of the Congress and the Administration, can help. And **you must do so.**

I'm concerned, however, that there are some, in and out of this industry, who are at least hinting, if not suggesting, that **instead of fully coming to grips with the problem, perhaps we ought to "throw it in the lap of the Treasury" -- that is to say, we ought to push the problem onto the backs of the taxpayers.** In my view, **such an approach would grossly irresponsible at best.**

Is there any conceivable rationale which could possibly be justified under the circumstances to foist off onto the taxpayers -- your neighbors, parents, sons and daughters -- the burden of losses sustained by member institutions in this industry?

Further, were this to occur...it would spell the beginning of the end of the (separate) Federal Home Loan Bank System as we know it. At that point, the Treasury would effectively be in charge of the FSLIC.

Clearly, **the FSLIC today is serving as the only real capital buffer to the risk of loss for the FSLIC, for far too many institutions.**

When that is the case: **when institutions choose to engage in excessive risktaking with inadequate levels of capital to**

cushion their own losses; when the mentality of "heads I win, tails the FSLIC loses" substitutes for the mentality of safety, soundness and prudence...then the FSLIC is placed at a clear disadvantage. And the risk of loss -- and indeed actual losses -- which must be borne by the reserves of the insurance fund are greatly compounded.

Indeed, in an industry where there is virtually **no tangible net worth** and where, for the industry as a whole, even the regulatory net worth level has now dipped below four percent, the attention which must be paid to excessive risktaking through new FSLIC underwriting standards (regulations) is not only **fully justified but entirely appropriate.**

Since the advent of deregulation, the FSLIC has been called upon to underwrite a far greater diversity and magnitude of risk.

This has not been made any easier by **severe staffing constraints,** both within the FSLIC itself and at the field examiner level. **These constraints are not imposed by the Bank Board** (reference to staffing and salary constraints imposed on the Bank Board by the Office of Management and Budget and the Office of Personnel Management).

This is why the legislative package the Bank Board will soon be proposing to the Congress will seek **the same sort of relative freedom the FDIC enjoys in adequately staffing up the FSLIC to meet its problems. And, in fact, this is why the Bank Board is seriously entertaining the possibility of moving our field examiners to the Federal Home Loan Banks.**

As you know, examination is the first line of defense for FSLIC. **Today our examination force is severely understaffed.** Further, given the **far lower salaries** the Bank Board is permitted to pay our examiners, compared to those paid to examination personnel in our sister financial regulatory agencies, we are continually subjected to **a revolving door scenario** where bright young examiners leave our force for better paying jobs, many departing after only several years. Many of them are hired away by your institutions.

The heavy turnover which results places that first line of defense for the FSLIC at a great disadvantage -- especially at a time when the need for well-trained examiners, who are prepared to audit far more sophisticated transactions, is **more crucial than ever.**

Deregulation has presented all of us -- we at the Bank Board and your institutions -- with immense and historic challenges.

That sense of discipline, that sense of responsibility -- which must always accompany new freedoms -- is more necessary now than ever before, if your savings institutions system is

to survive. A viable deposit insurance structure is an absolutely essential part of your business.

We all know there is a problem. And we all must face up to the problem. Indeed, we must all determine to work together in a team effort so we can be part of a solution which restores strength -- especially in the long term -- to this fundamental underpinning of our (national thrift) system, the FSLIC.

This is a time for courage, a time for leadership, a time for real commitment to preserving the credibility of the deposit insurance fund -- the cornerstone of your business.

Nothing is more important to your future than this.

From A Speech Before Management Conference,
U. S. League of Savings Institutions,
Washington D. C., March 12, 1985

24.

The Bank Board is currently facing tremendous staffing problems, particularly with respect to maintaining an adequate examination and supervisory force. In an era of deregulation...it is axiomatic that additional examination and supervisory personnel will be the necessary device to protect the insurance fund from excessive risk.

The Bank Board has solicited OMB's support for our efforts to remove the field examiners and their field nonadministrative employees from the appropriations process to the status now provided for employees of the FDIC. **(this request was denied by OMB).** (A Bank Board) task force is strongly considering recommending to the Banks Board that field examiners be made part of the Federal Home Loan Bank (FHLBank or FHLB) system.

We have learned that greater use of technology does not automatically decrease our staffing requirements for field examiners. In fact, in light of recent experience, we are facing a potentially acute shortage of examiners. Our growing concern is a growing asset quality problem among troubled savings institutions. **The acute need for (extra examiner) positions is reflected by the fact that the Board now averages about five institutions per examiner -- much more than the approximately four institutions per examiner of the three banking regulatory agencies, taken together.** The function of the examiner in today's far more sophisticated deregulated financial environment is more **crucial than ever** to our job of spotting problems early enough so that corrective action may be taken by supervisory agents before problems mount and ultimately become very costly disasters for the FSLIC.

Finally, **we are also seriously understaffed** with respect to **examination** of data processing operations in savings institutions.

In **response** to the **recommendations** of the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Government Operations Committee (Barnard Committee) we have requested the support of OMB for our efforts to obtain the necessary Congressional approval for legislation to remove our **field examiners** and other OES (Office of Examinations and Supervision) field nonadministrative **employees** from the **appropriations process.** Such a move would give our examiners equivalent status to that provided to FDIC employees. (OMB opposed this)

The difficult and fragile transition which thrifts have been facing has had profound implications for the FSLIC fund. **The fund is under enormous stress.** Absent strong remedial action, we foresee additional strains resulting from asset quality problems.

Since December 31, 1982 almost all income received by the FSLIC has been expended to solve problem cases. While it is very difficult to project with precision FSLIC reserve levels at the end of 1985, we would be derelict in our duties as managers of the FSLIC in your behalf if we failed to inform you at this time that our caseload trends do suggest the possibility that **such levels could be diminished significantly, both in 1985 and again in 1986, as a result.**

We are...very concerned about the kind of limits that we must operate under, with respect to OMB. ...In the legislative package that we will be sending to Congress, we are going to ask that the FSLIC also have the same ability to deal with its problems as the FDIC. We have, in comparison to the FDIC, only about 100 (professionals)...in comparison to the FDIC with at least several thousand people directly involved in the insurance function. Given the magnitude of our problems, and given the needed flexibility that we must have, to protect this (FSLIC) fund, we believe that it is entirely justifiable and appropriate (for the FSLIC) to be treated in the same way as the FDIC.

From Testimony Before The Senate Committee
On Appropriations, Subcommittee on
HUD-Independent Agencies, Washington,
March 13, 1985

25.

In all candor, any action (by the Financial Institutions Subcommittee, House Banking Committee) which would have the effect of unnecessarily delaying the implementation of the direct investment regulation would be tantamount to tying the hands of the Bank Board.

During the kind of period we are in, I am constrained to say that, with all due respect to you ladies and gentlemen on the Subcommittee, **the responsibility for the mounting losses to the FSLIC -- losses that we are now seeing from bad assets resulting from what have turned out to be bad direct investments -- would fall squarely on the shoulders of the Congress, itself, to the extent such a delay would impair our ability to deal with such problems as manages, and as the operating head of the FSLIC.** (The hearing was called to address concerns by more than half the members of the House of Representatives regarding the Bank Board's direct investment regulation)

Frankly, in my view...**the stakes are simply too important for our savings institutions system and the FSLIC to accommodate even the thought of, or mere contemplation of, delay (in implementing the direct investment regulation) at this very critical juncture.**

This (direct investment) regulation -- this insurance underwriting standard, if you will -- is only one of a number of critically important tools that we need to strengthen our hand in not only reducing the risk of loss to the insurance fund but also in helping to prevent further horrendous losses resulting from very costly bad assets. What we need now is your help, your confidence and support.

Unless and until the Congress gives us the right to underwrite risk through a premium payments scheme which assesses higher premiums on those institutions which choose to engage in more risky activities, the Bank Board...has no other avenue for imposing risk underwriting standards on the industry than through the regulatory process. This is why, last year at this time, the Bank Board proposed several regulatory approaches to underwriting the risk of loss to the FSLIC.

I recognize, of course, that **a resolution (signed by a majority of the members of the U. S. House of Representatives) has been signed**...which calls on the Bank Board to delay implementation of the final direct investment regulation. In my view, **it would be a fundamental mistake for the Bank Board to do so. And, we do not intend to do so.**

As I have stated on many occasions during my tenure as Chairman of the Federal Home Loan Bank Board, the Congress, of course, has every right to overrule our regulatory actions through the legislative process if it finds our decisions to be unsatisfactory or inconsistent, in any way, with intent of Congress.

When savings institutions can leverage very heavily in the market for funds off of relatively low levels of capital, and where this is virtually no correlation between the magnitude of growth to underlying, supportive levels of net worth, then the prospects of loss -- either to the reserves of the institution itself, or to the ultimate loss reserve represented by the by the FSLIC -- can be very great.

The failure to take appropriate measures to review direct investments at certain threshold levels before they are consummated, and before some could ultimately turn out to be horrendous losses for the FSLIC, would reflect a very serious lack of regulatory concern on the part of the Bank Board for dealing with the risk of loss, or the potential risk of loss, to the insurance fund. We understand that directed investments may turn out to be profitable for an institution. However, because they represent greater risk, they also can turn out to be disastrous failures, extremely costly failures, both to an institution and ultimately to the reserves of the FSLIC.

The ultimate potential bearer of loss from any activity engaged in by federally-insured depository institutions is the taxpayer, should the deposit insurance corporations themselves find themselves unable to meet their obligations.

From Testimony Before The Financial
Institutions Subcommittee Of The
House Banking Committee, Washington,
March 27, 1985

26.

I am compelled today to concentrate on matters I feel very strongly about -- sobering matters that demand a call to action.

As the chief regulator of the industry and the national thrift system, I am an officer of the United States government. My responsibilities go beyond any sort of representation of the industry.

I am called upon by law and by the direction of Congress to represent the interests of the public. I am not, nor should I be seen as, an extension of any trade association. This is not a proper role for a regulator, nor is it in your interest, or mine, that such a perception be inaccurately allowed to exist.

Thrift deregulation was never intended by the Congress to be the equivalent of trucking or airline deregulation. When an airline fails, it goes out of business. When a thrift fails, our federal deposit insurance system picks up the pieces. As it works out, there is really no true entrepreneurialism in the thrift industry because those who take great risks on the system generally do not risk their own money, but rather that of the FSLIC.

Let me assure you that I am an ardent advocate and committed supporter of the true capitalist principles of entrepreneurialism.

True entrepreneurs risk their own money. When they win, they may win big. When they lose they lose their own money. It doesn't really work that way for those who operate on the federal deposit insurance system -- that is to say, on the implicit full faith and credit of the United States of America.

Thrift deregulation was not intended by Congress of the United States to convert savings institutions into "entrepreneurial" enterprises. When an FSLIC-insured institution fails it is the federal safety net which protects the insured depositor.

No state treasury is ever exposed to risk of loss -- nor does any state treasury ever incur actual losses -- suffered by its own state-chartered, but federally-insured, thrift institutions. It is no wonder, then, that the Congress, in its role on behalf of the federal taxpayer, has approached thrift deregulation in a substantially different way from the way some states have gone about it.

Thrift deregulation was intended by the Congress of the United States to provide sufficient elbow room to enable savings institutions to restructure their asset-liability portfolios during a transition period, and to provide some additional avenues of profitability in order to strengthen their ability to "ensure" -- as the Garn-St Germain Act states -- "the availability of home mortgage loans."

(Again) Thrift deregulation was not intended by the Congress to convert savings institutions into "entrepreneurial" enterprises. Indeed, the Congress did not see fit to extend to federally-chartered savings institutions the authority to make direct (equity) investments, except in a relatively limited asset basket (3% of assets), through their service corporation authorities.

I recognize there are those who maintain that any state ought to be able to establish any (operating) authority, any activity it chooses -- any activity whatsoever -- irrespective of any public policy consideration whatsoever, for its own state-chartered thrifts.

That would make a lot of sense if (1) the state supplied the credit and (2) the full faith and credit of the state, itself, were pledged to underwrite the risk of loss to the state-

chartered institution. Such is not the case. And, anyone here who thinks his or her state is ready to such make a commitment to its own state-chartered institutions would be **out of touch with reality.**

The problem is, too many in this industry want to have it both ways, and in the name of "state's rights," they argue against any so-called infringement, whatsoever, on "state's rights." **They want full state authority to do anything, and everything, as long as the federal government is willing to shell out all the credit and pick up all the losses.**
Now, does that really make good sense? The fact is, this Bank Board is a supporter of a rational dual thrift system. But the system is no longer rational.

Today, movement toward increased liberalization of operating authorities (by state legislatures)...irrespective of the public policy implications, or the risk of loss which results from such activities -- or the actual losses (which can and) do result from such endeavors -- is counterproductive at best.

Many state governments have not committed truly enough supervision and examination resources to the regulation of their own state-chartered thrifts. We know that because we know our own FSLIC examination resources are inadequate. Fortunately, the Bank Board has taken unilateral action to remedy this unfortunate state of affairs. In little more than a month from now, on July 6 (1985), when the transfer of our own examiners to the Federal Home Loan Bank districts is completed, we will finally be able (to begin) to correct these deficiencies.

The manner in which our dual system has become irrational of late extends to another insurance related function. Last year at this (same) meeting, in Orlando...362 days ago...I said (to you):

"**Our insurance fund (the FSLIC) is quite literally a group insurance plan, upon which the fate of every insured institution depends.** To the extent one institution's activities incur losses to the fund, every other insured institution must share in making up that loss.

"The losses incurred by institutions which are imprudently operated, or which pursue activities which are substantially risky, come at the expense of those institutions which are operated in a sound and prudent manner. The hazards which are undertaken by healthy institutions impact on the financial well-being of every other member of the group plan."

Having pointed this out (to you) 362 days ago, the fact is **we still have such a group insurance plan today.** This plan is tantamount to a sort of welfare transfer payments system in which well-run and well-capitalized institutions are called upon to fund the risk of loss, and actual losses, incurred by other institutions which have chosen to engage in risktaking on inadequate capital, which all too often turns out to be the capital of the FSLIC.

This is why **last year at this time in Orlando I sought to make a very strong case for a risk premium plan which I believed then (and do now) would move us along very well toward a more rational (deposit) insurance system (for the FSLIC).**

We sent legislation (then)...which was introduced in the House and in the Senate. Again this year, the cornerstone of our legislative package -- which again has been introduced (in both houses) is the risk premium plan. Our proposal would...assess (additional supplementary insurance) premiums on those activities (engaged in by some state-chartered institutions) which go beyond the limits that Congress found to be suitable for regular insurance.

In other words, **to the extent an institution decided to engage in activities beyond the limits of the Garn-St Germain Act (beyond what federally-chartered thrifts are permitted) such a premium structure would be applied. Those institutions with high net worth...would be forgiven a portion of the risk premium.**

It simply does not make sense to me to continue to have to underwrite such risk by regulatory action, itself. We need to be able to **price the risk** of certain activities in order to be fair to those who choose to operate more conservatively and more prudently.

How can we be expected to run and insurance company (the FSLIC) effectively if we cannot price the risk (from loss from) certain activities in order to at least get control of -- and hopefully bring to a halt -- the huge losses to the insurance fund which we are now experiencing.

That, ladies and gentlemen, must be our **first order of business** or we simply won't have a chance to even begin to turn things around. And, in all candor, time is of the essence.

I do not believe we have the luxury to wait another year. In this regard, we simply cannot and must not deal with this very serious problem as an exercise in polemics in a debating society environment. This is a critical matter which you must face up to, and come to grips with, now.

When buying time for the sake of buying time; when putting off important decisions becomes an end in itself; when postponing the day of reckoning substitutes for critical action and

facing up to critical, hard realities; when presumably hard-headed businessmen and women fail to confront hard reality and choose to procrastinate while time and money slip away from their insurance fund -- yes, when putting off, and failing to come to grips with the most fundamental problem to confront this industry in a half century makes reaction a substitute for constructive, affirmative problem-solving action, then the consequences of pursuing such a course become harbingers of worsening, and ultimately destructive, ends.

Again, I call upon you -- the leaders of the savings institutions industry -- **to work to find a way -- now --** to provide for the long-term replenishment of the reserves of the FSLIC. **You must help us at the Bank Board, in our efforts to bring greater discipline to the operations and practices of the industry, and in our efforts to pass legislation this year** which is truly adequate to the nature and magnitude of the task -- **if** the Federal Home Loan Bank System as we know it is to **survive** out into the future.

The train has left the station and it's moving down the track, whether anyone may like it or not.

In just less than a year since I last discussed these sobering issues with you...the chickens, bearing huge losses to our fund, are indeed coming home to roost. Rose colored glasses may be attractive and beguiling, but they distort a true picture. This, my friends, is the cold light of morning.

I make no apologies for being so intense and so concerned about the problem. Please take my word for it. You have just as much reason to be concerned about this problem as I do -- indeed moreso.

The time to act is now. I would hate to see our system unravel and come apart, simply because some activities would be viewed as so outlandish as to prompt other measures from other less sympathetic quarters.

(Again) I want to urge you again to support the (FSLIC) risk premium concept (legislation before the Congress) the Bank Board has proposed, and to deal with the challenge to find a **long-term solution to replenish the reserves of the FSLIC fund.**

I believe the full faith and credit of the United States stands behind insured accounts at our institutions. But, such references to the "full faith and credit" are not, cannot be and must be allowed to substitute for the kind of discipline which we all must impose on ourselves to assure that we never actually resort to the real "full faith and credit of the United States," taxpayers' dollars supplied by the U. S. Treasury.

In my opinion, this industry would pay a very dear price indeed -- a price no one in this room would ever want to pay -- if the taxpayers were ever asked to rescue FSLIC.
The time has long since come and gone for engaging in the luxury of nitpicking efforts we are trying to make to give the industry and the insurance fund a chance to survive.

We must return to a greater sense of discipline in the (thrift) industry. We must all begin now -- not tomorrow, not next month, not next year, but now -- to work to make prudence, safety and soundness the cornerstone of the thrift system, once again.

From A Speech Before the Conference Of The
Committee On Larger Institutions, U. S.
League Of Savings Institutions, Palm
Springs, California, May 29, 1985

27.

I recognize that there are very powerful financial forces in the lobbying community, some investment banking houses and other money brokering operations, which have sought to prevail on members of Congress in their own corporate interest and frankly, in my view, against the interest of a safe and sound Federal Deposit Insurance System.

Employing their financial might in an effort to run roughshod over the deep concerns of those of us...who are mandated by law to manage and protect the reserves of the Federal Deposit Insurance System, they have succeeded in at least muddying the waters and successfully leaving the impression in some quarters that brokered funds have played no possible role in the failures we have encountered.

Indeed, these money brokering operations have sought to leave the impression in too many instances that such money brokerage has wrought no harm on the Federal Deposit Insurance System at all. Those at fault, they say, were not the money brokers but rather insured institutions which invested the funds poorly. The money brokers and the brokered funds, they claim, were simply innocent bystanders, harmless participants in the death dance of failed and failing institutions.

Those who believe such stories are likely to believe in fairy tales. The fact is, in far too many cases it was the easy, instantaneous access to very willing money brokers, willing to provide high-priced federally-insured money to any institutions which sought it -- in virtually unlimited amounts -- which fueled the rapidly-made investments and loans that have become very bad assets in some of the most significant thrift failures we have seen.

And, who was left to pick up the pieces? Your Federal Deposit Insurance System.

I know there are those who don't appreciate hearing what I have just said, **but so far as I'm concerned, it's the simple truth of the matter,** and in all honesty it has increased the strains on your Federal Deposit Insurance System.

Regulating for safety and soundness to safeguard the resources of our federal deposit insurance funds is not easy. It...demands integrity, firmness and a full-fledged commitment to uphold the spirit and intent of the law.

I believe this is the principal reason why the Congress has established the independence of the federal deposit insurance agencies. This independence serves and has served this nation for a long time now.

We are not interested in protecting the corporate self-interest of any lobbying giant when it comes to the Federal Deposit Insurance System. But, we are interested in, and we are committed to, the task of protecting and safeguarding the safety and soundness of our deposit insurance system and the reserves of the system in your behalf, and in behalf of the American public...

From Testimony Before The Subcommittee
On Financial Institutions And Consumer
Affairs Of The Senate Banking Committee,
Washington, June 5, 1985

28.

Never in the history of the (savings institutions) business has the need for a combination of perceptive understanding and resolute firmness...confronted any Bank Board (more than this one).

Recapitalization of the FSLIC is what is most necessary to assure that our insurance corporation will always be able to meet its obligations.

I would surely be less than candid if I did not take this opportunity to remind you that for almost my entire tenure as Chairman of the Federal Home Loan Bank Board I have been raising red flags about the course we were on, in terms of our ability to protect the FSLIC from mounting thrift failures and developing losses which were occurring -- and yes have occurred -- as the result of excessive liability and asset growth and poor loan and investment underwriting by too many savings institutions.

Yet, up until only recently too many in the (thrift) industry simply ignored the danger signals for the FSLIC, irrespective of the concerns we at the Bank Board were expressing for two years.

All during last year, and earlier this year, there was precious little support from many industry quarters for initiatives the Bank Board sought to take to strengthen the FSLIC's ability to correlate net worth much more closely with growth; to better underwrite the risk to the fund of direct equity investments; to reform the manner in which regulatory net worth is calculated, by phasing out five-year averaging; and to get a handle on the distinctions between direct investments and ADC (acquisition, development and construction) loans.

All of these initiatives were intended to serve as protection for the finite reserves of the FSLIC.

You will recall how **more than half** the members of the House of Representatives **opposed or sought significantly delayed implementation of** the Bank Board's direct investment regulation (which was adopted in spite of intense pressures from certain quarters in Congress).

In spite of all that has occurred (in this regard), there are still those ... who apparently have refused to recognize the need for an injection of discipline -- that is to say strong medicine -- in the thrift regulatory and deposit insurance scheme of things.

There are still those in the industry who have chosen to bury their heads in the sand and have failed to grasp the magnitude and seriousness of the challenges the national thrift system has faced for several years now, challenges we face today, and acutely difficult challenges we will continue to face in the future.

The continuing strains on the FSLIC require a forthright recognition by the leaders of this industry of the growing need to recapitalize the FSLIC. This can only be done through a willingness and commitment to strengthen the ability of the FSLIC to meet its financial obligations.

Anyone who believes the Congress is of a mind to tap **taxpayer-supplied revenues to do this**, except as a very last resort, is under a false delusion. The Congress would choose the alternative -- of merger of the FSLIC into the FDIC -- long before it ever chose the last resort I mentioned -- namely **tapping the federal taxpayer**.

Recapitalization of the FSLIC is at the very heart of the issue (as to whether the separate and distinct savings institutions system will endure). (The issue) simply must be dealt with and not left to polemics which produce inadequate answers.

How the FSLIC is recapitalized is a legitimate subject for discussion. **Nevertheless**, however recapitalization is accomplished, it must be accomplished.

Those who were suggesting last year, and earlier on this year, that we at the Bank Board were somehow crying wolf surely must recognize now the basis for the concerns we expressed then, given the horrendous failures we have seen recently.

From A Speech Before The Annual Convention
Of The California League Of Savings
Institutions, Honolulu, Hawaii
September 19, 1985

39.

In the new (deregulated) operating environment (for thrifts) of 1983, authorities granted by Garn-St Germain were superseded by far more liberal operating authorities authorized by some state legislatures. **This...was bound to bring with it new and unprecedented strains on the thrift deposit insurance system.**

Early in my tenure the Bank Board did recognize danger signals on the horizon. **We saw the emergence of asset** quality changes in the portfolios of (some) institutions and we joined with the FDIC in seeking to slow the skyrocketing growth of third-party brokered deposits which we believed were fueling excessive growth in loans and investments.

We believed then, and **we have been proved correct over and over again**, that excessive deposit growth would bring about unecessarily risky investments and loans which we feared would sacrifice prudent and sound underwriting practices in a frenzied rush for up-front fees.

Unfortunately, in this period there was on the part of too many savings institutions **an "anything goes" attitude**; a tendency to confuse the purposes Congress had in mind for thrift deregulation with safety and soundness imperatives, both at the level of the institution and also at the FSLIC.

In early 1984, I warned that **thrift deregulation was on a collision course with the FSLIC.** I **expressed** particular concern on many occasions that our ability at the FSLIC to underwrite the risk of loss to the FSLIC from activities permitted by some state legislatures, especially in the Sun Belt, was difficult at best.

As it turns out **our biggest, our most horrendous thrift failures have occurred at such institutions.** Common threads are woven through the fabric of such failure: exceedingly fast growth, very **high levels of brokered funds, very** poor underwriting of loans and investments, shoddy management systems and practices, atrocious recordkeeping and documentation, and questionable, misleading -- and sometimes fraudulent -- behavior by those vested with a public trust, as executives of insured depository institutions.

The consequence of the experience -- wrought more often than not on the thrift deposit insurance system by high fliers and daredevils who have chosen to play fast and loose in the system, with a mentality that can best be described as "heads I win, tails the FSLIC losses" -- is incredible losses (to the FSLIC).

I do not believe the thrift deposit insurance system can endure long unless it is modernized and a way is found to more effectively underwrite the risk

The (FSLIC) fund must be recapitalized. The alternative -- that of deferring action on cases now before us and projected to come before us in the future-- can only result in greater costs to the FSLIC down the road.

What you in Congress must deal with -- and I urge you to act expeditiously -- is the issue of how the thrift deposit insurance fund will be recapitalized. Since we at the Bank Board don't print money, there are in my mind only two sources of recapitalization: The Treasury or the thrift industry member institutions of the FSLIC.

The only two alternatives to thrift industry recapitalization of the (FSLIC) fund are a possible merger of the FSLIC -- which I do not favor -- or a taxpayer-financed recapitalization.

The only alternative to recapitalization (otherwise) is a continuing deferral of action by the Bank Board on major problem cases... Such a deferral of action can only cause case resolution costs to increase over time. Again, the Congress, in my view, must...deal with this issue expeditiously.

From Testimony Before the Financial
Institutions Subcommittee Of The
House Banking Committee, Washington
October 17, 1985

30.

Regulators are not picked to win, and should not be expected to win, popularity contests. Regulators are, in no sense, extensions of industry trade associations. Regulators are traffic cops who take a solemn oath to uphold the spirit and the letter of the law, and carry out their duties accordingly.

This is why the Congress...many years ago made the Federal Home Loan Bank Board an independent regulatory agency to shield it and insulate it from undue political pressure.

I am not at all enamored of imprudent and excessive risktaking engaged in by **high fliers and daredevils** in the industry. Their actions can only bring **harm** to the FSLIC.

Responsible members of the FSLIC -- those in the industry who operate carefully and prudently and eschew excessive risktaking, those who work to build up their retained earnings using sound management practices to accomplish their business goals -- **are the ones who, in the end, are forced to pay for the excesses and ultimate failures of institutions which have not acted prudently and responsibly.**

It would be redundant in this forum to again go into my concerns about the **(worsening) condition of the FSLIC.** My views are generally well known in that regard.

However, my concerns are **very real.** And they deserve your constructive and very serious attention. Failure to come to grips with them -- sooner than later -- can only make the national thrift system as currently structured **more vulnerable to measures which could, in time, seriously alter the character and structure of the (thrift) industry itself, as we have known it for a half-century.**

The stakes for the future of the thrift industry are simply enormous. Removal of the FSLIC from our national thrift system would cut the heart of the system. And, if this were to happen, others who traditionally have had far less sympathy for the role of thrifts in the national financial structure would end up making the (deposit) insurance rules for all of your institutions.

Your insurance fund, the FSLIC, cannot operate on hot air. We do not print money at the Federal Home Loan Bank Board. In order for us at the FSLIC to meet and deal with the insurance corporation's obligations, we must have the (financial and staff) resources to do so. The only alternative is to defer resolution of cases as best we can, (again) in the absence of sufficient resources to do otherwise.

Regulators are not elected. Regulators do not make laws. (Only) the Congress is elected to make laws and to bring about statutory reforms. Our (the Bank Board's) proposals to bring about thrift deposit insurance reform have been considered by both the Senate and House Banking Committees.

Ladies and Gentlemen (of the industry), the ball is in your court. The Congress will act, and act swifty, on reforms which achieve consensus in the industry, if you but push for them. In my view, the time has long since come for meaningful

action in this regard. Delay serves no useful purpose. ...Its effects can be deleterious for your future.

Among additional actions which I believe are necessary for the long-term health and survivability of the FSLIC is a reform of the manner in which the risk of loss to the FSLIC is underwritten.

Trying to maintain our present deposit insurance scheme -- specifically our "group" insurance plan -- is not at all unlike trying to force a round metal peg in a square metal hole. It doesn't work and there's no way it really can work in these times. "Group" insurance plans that have to accommodate all risks (of loss) need very deep pockets to make it. On the other hand, the resources of the FSLIC are limited and finite, and they will continue to be limited and finite.

You as an industry need to address these challenges with the greatest possible seriousness -- expeditiously. That means **soon!**

There must be, there simply must be, a renewed sense of discipline, self-discipline, in this industry. Safety and soundness and prudence may sound old fashioned. I assure you, these are not trite concepts. They spell the difference between survival and failure. They are as close to eternal verities as we can ever know in the savings institutions business.

From A Speech Before The Annual Convention
Of The U. S. League Of Savings
Institutions, Dallas, Texas
November 5, 1985

31.

The severe financial crisis that has plagued the thrift industry over the past several years has taken its toll **on the Bank Board's capacity to examine and supervise** the institutions under its jurisdiction.

During this time, we frequently have had to use our limited resources to handle only critical situations, rather than to engage in systematic, well-designed examination and supervision aimed at preserving the health of institutions. This situation, if allowed to continue, could destroy our ability to protect the safety and soundness of the thrift industry.

The Bank Board has taken action on many fronts to deal with the problems and constraints facing the Board and the FSLIC. We have attacked the problem of staffing limitations by delegating the examination function to the Federal Home Loan Banks (FHLBanks).

The Board has conferred independent office status on the former Division of Enforcement within the General Counsel's Office. I have issued a series of directives requiring immediate written notification to the new Office of Enforcement of any material violations of law, regulations or written agreements entered into with the Bank Board by insured institutions when detected by the supervisory agents in the field. The Board is also aggressive in making criminal referrals (to the Department of Justice) whenever warranted, in bringing suit against the individuals who have caused thrifts to fail, and in seeking judicial orders freezing such persons' assets.

(On) July 6, 1985, the Bank Board transferred its field examination function to the Federal Home Loan Banks (FHLBanks). By December 31, 1985 the number of examiner professionals the number of examiner professionals on the staffs of the FHLBs, an increase of 34.3 percent. Of this increase, 120 or 46.9 percent were in the Atlanta, Dallas and San Francisco districts where many of the most serious industry problems exist.

The FSLIC fund remains under enormous strain and the Bank Board and FSLIC staff resources continue to be stretched severely. At year-end 1985, the total FSLIC insurance reserve amounted to just over $6 billion and the ratio of reserves to member institutions' deposits remained at about 0.72 percent.

Moreover...government staffing and pay scales, and the new constraints of Gramm-Rudman-Hollings impose severe restrictions upon us and will cause further unecessary losses to the FSLIC fund.

The unacceptably low ratio of FSLIC reserves to (insured) liabilities imposes severe budgetary restraints on the number of cases the FSLIC can resolve because the resolution of a bad asset case almost invariably requires substantial FSLIC financial assistance.

The Board supports reform of the current flat-rate deposit premium structure. (Some) state legislatures have exceeded the confines of the activities that Congress deemed suitable for federal-chartered savings institutions to engage in all types of "entrepreneurial" endeavors, without protecting the federal insurance fund from the increased risk.

We have asked Congress to examine closely the apparently unintended results of thrift deregulation which goes far beyond the intent of the Garn-St Germain Act.

As currently structured, FSLIC insurance coverage creates two perverse incentives for excessive risk-taking. Deposit insurance protection becomes an external substitute for the equity or risk capital of thrift institutions, creating a "moral hazard" in insurance terminology. The current structure offers an enormous incentive to troubled institutions to take "all-or-nothing" gambles at the FSLIC's expense.

(We) would establish groupings of activities based on risk of loss, and subject them to appropriate risk premium pricing.

The second prong of our legislative agenda would provide the Board with a wider array of strengthened enforcement tools to monitor risk-taking and avert substantial losses to the FSLIC fund by taking supervisory action before unsound practices have forced an institution into insolvency.

Our proposal deals specifically with statutory language that has made expeditious enforcement action difficult in the past, and would grant new authority to halt new lending or other activities when there is a failure to maintain adequate books and records. The bills also strengthen our enforcement options by expanding the classes of affiliated persons and companies subject to the Bank Board's cease-and-desist and removal and prohibition authority.

When compared to the total number of insured institutions supervised by the Bank Board, the number that face formal enforcement actions each year is small, but the impact of outdated statutes that hinder effective action in such cases is major, compelling us to seek legislative resolution.

(Our proposed legislation) would limit the activities of any FSLIC-insured institution to the following activities: (1) mortgage loans and other activities authorized for federal savings and loan associations; (2) business activities which multiple savings and loan holding companies may engage in under the National Housing Act and regulations of the FSLIC, and (3) such other services as the FSLIC may approve as a proper incident to the operation of insured institutions and not detrimental to the interests of savings accountholders.

From Testimony Before The Subcommittee
On HUD-Independent Agencies Of The
Senate Appropriations Committee,
Washington, February 20, 1986

32.

I was not, nor have I been, shy in stating, from a regulator's perspective, the consequences of an institution's failure to exercise caution, care and prudence in the exercise of new thrift operating authorities. **All of us have viewed...with deep concern, and even horror, the parched, poisoned harvests which have grown from the seeds of imprudence.**

The cost of failure by too many managements of thrift institutions to observe time-tested, sound management practices -- that is to say borrowing, lending and investment standards -- has been very substantial indeed.

This is especially true for those many responsible and prudently operated institutions in the thrift industry which, through their support of the deposit insurance system (through the payment of insurance premiums to the FSLIC), are now called upon to make increased premium contributions in support of that "group" insurance fund. You know, all too well, that high fliers have and become very expensive.

As I look back to 1983 and 1984, there was, unfortunately, a mentality among, too many in the industry that somehow thrift deregulation meant the regulator -- the supervisor -- had been consigned to the shadows, assigned a disappearing role.

There was a mentality on the part of too many that less regulation, (that is to say) deregulation, meant fewer supervisors, fewer field examiners, and no new rules. The Department of Savings and Loan in California, the primary regulator of state-chartered institutions (in the state), had been reduced by a previous (state) administration to virtual impotence, relative to the number of institutions it was responsible for, as their primary regulator.

Ironically, at that time, more than three years ago, the California legislature granted unprecedented operating authorities for state-chartered savings institutions.

In Washington, federal budget and salary-setting constraints on the Bank Board, (by the Office of Management and Budget -- OMB; and by the Office of Personnel Management -- OPM) which exacerbated our own problems in examining and monitoring the activities of FSLIC-insured institutions in the new and highly diverse operating environment for thrifts, were yet another reflection of a mentality which failed to take into account the true role of the regulator in a deregulated asset/liability environment.

The confusion which existed in and out of the industry in this new environment was further compounded by the assertions of some, that somehow, instantaneously, the lines between thrifts and commercial banks had become so blurred as to have removed any further need for a separate (thrift) system with its own regulatory, deposit insurance and credit facility components.

In...too many cases, the new elbow room which Garn-St Germain provided was abused by some who did not choose to recognize their public charter as the equivalent of a public trust -- to serve the public -- but rather as a quick route to a fast buck.

Some, driven by pure greed, played their new powers like th
would a roulette wheel in Las Vegas, knowing that someone el
would pay in the event their gambles didn't pay off. As
turns out, many of you are paying the price of the
irresponsibility and indeed profligacy.

A pervasive aspect of the mentality which existed for too lo
was that the answer to any problem was to grow out of it. T
freedom to raise insured funds, at almost any price, and
almost any rate of growth, resulted in growth rates in 19
and 1984 which assumed astronomical, indeed staggeri
proportions.

That is not the case anymore. In December of 1984 -- aft
having failed to get control of these excesses early
through a brokered funds regulation which the feder
judiciary found to exceed the statutory authority of the FSL
and FDIC -- The Bank Board hunkered down and proposed a ru
which was intended to correlate deposit growth with net wort
That regulation, whose principal thrust was to require FSLI
insured institutions to earn their growth, was adopted litt
more than a year ago, over the strenuous objections of many.

Over the vehement objection of a significant segment of t
industry, and in the face of a House resolution signed by
majority of the members of that body, whose purpose was,
fact, to derail implementation of the Bank Board's dire
investment regulation, we stood our ground.

You will recall that from the fall of 1983 onward, I beg
warning both the industry and the Congress that (a) changi
phenomenon did not bode well at all for the future health
the FSLIC. It was clear that the skyrocketing growth
deposits -- especially funds supplied to high risktakers wi
real, low levels of capital -- were being invested too oft
in highly speculative...highly risky real estate projects.

These repeated warnings (by me) continued to fall on too ma
deaf, or at least indifferent, ears, because action at all t
many levels (in the Congress and in the thrift industry) w
avoided. "It can't be all that bad, Ed," people (in th
industry) used to say to me. "Just relax," some of them sai
"Everything will work out alright. It alwayr has, " some
them added.

In the meantime, we at the Bank Board had a regulatory syst
which wasn't at all suited to dealing with the magnitude
difficulties we knew we were facing. We had an antiquat
regulatory structure which was built to accommodate a f
smaller universe of problems. But, throughout th
sunbelt...and yes elsewhere, our problems were growi
steadily.

We literally begged for help from OMB (Office of Management and Budget) time and time again to beef up the size of our field examination force. When there was any response, it was at the pace of a slow trickle.

Without adequate and capable supervisory and examination resources we cannot effectively stay on top of problems which deserve close, ongoing attention to better protect the FSLIC's resources. Without these professional human resources, we cannot expect to do the critical job, which must absolutely be done to maximize protection of the insurance fund in a deregulated operating environment.

From A Speech Before The Annual Management
Conference Of The California League
Of Savings Institutions, March 5, 1986

33.

Hampering our efforts to provide adequate and timely supervision are outmoded and time-consuming enforcement authorities which do not reflect, and cannot respond quickly enough to, the volatile and fast-changing financial environment in which thrifts compete.

...the Board will be requesting a number of legislative changes to strengthen the enforcement tools it uses to monitor risktaking and avert substantial losses to the FSLIC fund.

The first (would) strengthen the Board's authority to issue temporary cease-and-desist orders.

At the present time, a temporary order that is immediately effective may be issued only when an alleged violation or unsound practice is likely to cause insolvency, a substantial dissipation of assets or earnings, or a serious weakening of the financial condition of the institution.

Because our statute allows an institution or individual served with such an order to challenge the temporary order within 10 days in U.S. District Court, the Bank Board cannot simply state that the violation is one that may produce serious losses.

Instead, it must stand ready to prove those losses in court at the time it serves the temporary order on the institution.

The result is a loss of valuable time while the Board gathers proof of insolvency or substantial losses, even though we know through facts gleaned from our examination process that a serious problem exists at an institution.

To correct this situation an amendment is needed to remove th modifiers of "substantial" and "serious" before the finding of "dissipation" or "weakness" in such emergency cases.

Another integral part of the needed improvements to our cease and-desist authority is the addition of a new provision whic would enable the Board to issue a temporary order to halt a institution's making of new loans or investments whenever w are unable to determine the true financial conditions of a institution, despite the efforts of our examiners, because o the disarray in, or lack of, books and records.

Deficient recordkeeping has been a recurring theme in the mor serious thrift failures over the last two year.

Such an addition would empower the Board to halt any ne lending by an institution until the institution's books an records are in an acceptable condition-- in order for ou examiners to determine the financial condition of th institution.

We (also) are seeking specific statutory authority to defin by regulation, what constitutes an unsafe and unsoun practice, pursuant to the National Housing Act.

Such legislation would enable the Bank Board to move mor quickly to halt unsafe and unsound practices and take contro of institutions sooner, before they cause significant losse to the FSLIC. My prepared statement contains numerous othe suggested statutory changes.

From Testimony Before The Senate Banking
Committee, Washington, March 13, 1986

34.

(There was in 1983)...a rigid, determined mentality in th thrift industry generally, though not in all quarters by an means, that deregulation meant what it seemed to say -- tha all the wraps were off. The mentality was pervasive.

Simply stated, the mentality was: We are now going to grow ou of our problems. The law -- deposit deregulation -- is th law of the land. Deposit growth was skyrocketing out control in a significant segment of the thrift industry.

Without safety and soundness at individual thri institutions, how can we possibly ever hope to maintain a sa and sound deposit insurance system.

Today, we seek a recapitalization of the FSLIC because it absolutely necessary. What has brought us to this point is failure on the part of many parties to learn that safety an soundness does not happen automatically, and that th

combination of excessive growth and excessive risk on too little capital -- and the failure to observe and follow sound operating practices in banking which incorporate these time-honored principles -- will surely exact a heavy price which someone, at some time, will have to bear.

The thrift industry is paying that price and will continue to pay for it for years to come. But recapitalization (of the FSLIC, financed by the thrift industry) will only serve the long-term interests of the industry if the thrift industry is willing...to begin the long climb back to capital strength and operating discipline.

Our most important task as members of the Federal Home Loan Bank Board is to work to protect the FSLIC. It is automatic that in a deregulated environment, the role of supervision must play an extremely critical role, and an even more important role, in the regulation of insured (thrift) institutions. It is also clear to me that the greater the capital strength of the industry -- that is to say, the greater the capital cushion on which the industry operates -- the less need there is to regulate through rulemaking for insurance purposes.

From A Speech Before The Annual Spring Banking
Seminar Of The Morin School Of Banking
Law, Boston University, Boston,
Massachusetts, May 2, 1986

35.

(On December 3, 1984, speaking before this same group in San Diego) I was sitting in the front row, waiting to be called to the rostrum, listening to the opening remarks. Your presenter-introducer looked directly at me and requested that the Bank Board abandon the regulatory initiatives upon which it was embarking. He said that if we did just nothing, if we would only let the industry handle things its way, if we could only go along with a laissez-faire posture, everything would work out just fine. It was a call to the regulators to avoid any rulemaking.

My remarks essentially demonstrated that I respectfully disagreed. I pointed out that, in my opinion, the evidence was clear and overwhelming that steps had to be taken to slow the growth of the industry generally because it was simply out of control; that the frenzied growth spiral was accompanied by unacceptably excessive risktaking...and that what was taking place posed a clear and distinct threat to the future viability of the FSLIC. It was a deep concern I had been conveying to the industry and to the Congress for many months.

The Bank Board went on -- in the face of unprecedented fury and opposition on the part of many quarters in the industry -- to adopt at the end of January of 1985 the net worth/growth regulation and the direct investment regulation. In my opinion, had we failed to do our duty then -- unpopular as the initiatives were, which we chose doggedly to pursue -- the enormous difficulties the FSLIC faces today would have become far worse...

Unfortunately, the warnings I had been making for more than a year previous to that San Diego speech had simply been ignored by far too many in the (thrift) industry. Those impending danger signals I had been raising repeatedly, in speech after speech, in congressional hearing after congressional hearing, were seen by too many in the (savings institutions business) as unfounded exaggerations.

When (the) combination of unsafe, unsound and imprudent practices requires firm correction by the regulators, in the interest of protecting the FSLIC, it becomes a dereliction of duty for the regulators to fail to act accordingly -- even if some in the industry choose to brand such correction through prudential rulemaking as some sort of evil "re-regulation."

Unfortunately, safety and soundness were too often confused with "re-regulation." And, the industry and the FSLIC have suffered the consequences of this mentality on the part of some.

The notion that thrift deregulation somehow was intended to exile the regulator from the scene, to end prudential regulation intended to protect the finite reserves of the FSLIC...is a notion which simply cannot stand the test of reality in our federally-insured thrift depository institutions.

When we entered the new era of thrift deregulation in 1983, a pervasive mentality existed among too many in the industry that so-called deregulation constituted a license to abandon tried and true safety and soundness principles -- principles as old as banking itself.

The danger signals for the FSLIC were evident and addressed repeatedly in my remarks to various industry groups and in congressional hearings beginning in late 1983. The deteriorating reserve levels of the FSLIC were referred to time and again, in connection with my efforts to encourage the industry to come to grips with the problem.

Congress has a unique window of opportunity to take action on our recapitalization proposal (legislation to recapitalize the FSLIC). By providing resources to the FSLIC to begin a program of case resolutions now -- before conditions deteriorate (further), confidence in the FSLIC will be bolstered.

You in the thrift industry, and we who serve in our public capacities, have witnessed what happens when a mentality emerges that tends to sublimate the ongoing verities of safety and soundness and prudence to other pursuits -- including excessive risktaking fueled by excessive growth on too little net worth, as well as pure greed, insider dealing and outright fraud.

Discipline is a necessary requisite for a safe and sound thrift industry and a safe and sound FSLIC.

From A Speech Before The Annual Conference
Of The National Council Of Savings
Institutions, Boca Raton, Florida
May 6, 1986

36.

This is my fourth calendar year as Chairman of the Federal Home Loan Bank Board. During these years we have seen a steady decline in the resources of the thrift deposit insurance fund. I wish it had been otherwise.

The Bank Board has taken many regulatory measures to deal with very significant challenges along the way. I have kept you (the members of the House Banking Committee) fully apprised of the range of difficulties we have confronted, progress we have made in dealing with them, as well as the strident, sometimes furious opposition some of our regulatory initiatives have generated in some quarters of the thrift industry.

Nevertheless, we have stuck to our guns -- especially when the going has been the toughest...

Regulators who try to win popularity contests with those they regulate -- through inaction and failure to address forthrightly the clear and present dangers to the deposit insurance system -- can only fail ultimately to serve the public interest as well as the continuing best interest of the industries they are called upon to regulate.

The residual effects of excessive growth and excessive risktaking among too many thrift managements, especially in 1983 and 1984, when thrift deregulation was too often seen as a license to engage in heavy excesses on far too little capital, are with us today.

We have learned painful lessons along the way. To some, especially some in key positions in government (this reference was specifically intended to apply to OMB, the Office of Management and Budget), there was a failure to recognize that deregulation necessitates authorization of the human resources necessary to monitor and supervise insured institutions

closely, especially in a deregulated (thrift) operating environment.

Until the middle of 1985, when the Bank Board simply took matters into its own hands -- after having been repeatedly denied the field examination resources we needed to look into **the condition of institutions which were knee-deep in problems or which have since failed -- until then, we were in the position of having to try to regulate for safety and soundness with our hands tied behind our backs.**

Today as we discuss **the recapitalization of the FSLIC, we cannot but keep in mind the heavy price which must be paid to extricate ourselves from the circumstances which exist -- namely inadequate insurance reserves to deal with the nature and magnitude of the problems we face in seeking to resolve present and anticipated thrift failures.**

Recapitalization of the (thrift) insurance fund was a necessity last year. It must be dealt with this year by the Congress, given the hundreds of cases which must be resolved through additional FSLIC assistance. I am convinced that nothing, simply nothing, is more important than this if we are to begin to deal with the problems we face in a truly adequate manner and thereby restore the fullest possible measure of public confidence to the nation's thrift system. It has been my deep conviction that under these continuing, worsening circumstances for the condition of the FSLIC that strong doses of regulatory discipline be injected into the thrift system.

On the other hand, recapitalization of the thrift insurance fund cannot serve as more than another interim device, cannot serve as an ultimate solution unless we who govern the FSLIC have the full range of regulatory tools, affirmed by statute, that we need, as well as all the highly-trained examination and supervisory oversight personnel we need, to assure to the best of our ability that we do not find ourselves ever again in the same position we were in during the early two years of thrift deregulation, 1983 and 1984, which came so swiftly on us.

The enforcement tools **(legislation presented to the Congress by the Bank Board)**...will go a long way to assist us in this regard well out into the future. We must, in my view, address soon -- this year -- what I believe is the very real need for enhanced enforcement tools...

From Testimony Before The Financial
Institutions Subcommittee Of
The House Banking Committee,
Washington, May 8, 1986

37.

We at the Bank Board have tried to build into the regulatory proposals we have made (and adopted) supervisory review thresholds whereby we give our principal supervisory agents the ability to make decisions based on the track record, management capability and financial strength of institutions. Supervisory review thresholds may be exceeded in many cases, depending on the (financial strength and managerial capability) the institution itself.

We will continue to build in this technique within the regulatory scheme whenever possible so that we do not regulate to the lowest common denominator. Again, we are acutely aware of the need to not penalize institutions which have good managements, good track records and are in good financial condition.

During these past few years, with the FSLIC under such incredible strain, rulemaking has been necessary. To the extent we don't move to substantially increase real capital levels throughout the industry, rulemaking will be the inevitable result. We would like to rely to a far greater extent on effective and sure examination and supervision, instead of "rulemaking" as such. Capital is the secret to the success of this approach. ...Our regulations are (by and large) "insurance" regulations...to protect the FSLIC.

I have won no popularity contests with this industry. Nor will I try to do so.

(With respect to recapitalization of the FSLIC), the taxpayers are not going to come up with any money and you should not expect members of the Congress to come up with the money.

From A Speech Before The First Annual
Regulatory Policy Conference,
U. S. League of Savings Institutions,
Washington D. C., June 12, 1986

38.

Unfortunately, the Federal Home Loan Bank System and the (thrift) industry were not ready for what was provided under (the) Garn-St Germain (Act of 1982).

Only six months after I became Chairman, the change from spread problems to asset quality problems was clear to me. These problems were worsening steadily.

I warned...that the excessive growth in high-priced deposits which was occurring at the time was chasing too few good assets around the country. That's why we have so many see-through office buildings in some parts of the country today where vacancy rates are so high.

Growing for the sake of growing, accumulating vast reservoirs of expensive deposits and immediately investing those funds in highly speculative projects which were very poorly underwritten has spawned the huge burdens we bear today at the FSLIC.

Too many institutions in this industry chose to forget the public trust which was vested in them. They forgot that they had been given a very special privilege not available to others to take in funds -- that is to say, other people's money which is guaranteed by the government -- on which they run their institutions.

The ability to operate a publically-chartered savings and loan association, to borrow money from the Federal Home Loan Banks, to access funds which are insured by the FSLIC, and to operate on the implicit full faith and credit of the United States, demands a very special responsibility -- which is the equivalent of a public trust. This constitutes a public-private sector partnership, and with it comes certain obligations -- to be careful and prudent and responsible, and to operate in a safe and sound manner which befits the public trust. But, some have forgotten that responsibility.

The taxpayers did not cause any problems in the savings and loan business. I've heard some people in the industry say the government ought to bail out the FSLIC. What they're saying is that the taxpayers ought to bail out the FSLIC. I disagree.

We must stop the hemorrhage of losses from the FSLIC in the future if we are to successfully work ourselves out of today's severe insurance fund problem.

We have proposed that the minimum net worth requirement for the (thrift) industry be phased up over six years to six percent. I understand a trade association (the U. S. League of Savings Institutions) is apparently proposing that we take 12 years to reach six percent capital. Given what we've been through in the last six years, the idea of waiting until the turn of the century to reach six percent net worth in the (thrift) industry is absurd.

Without the FSLIC there will not be a savings and loan industry. It's important that we have the tools to protect the FSLIC. We (the regulators, the congress and the thrift industry) simply must come to grips honestly and forthrightly with the tough issues which jointly face us. We must not look for the easy way out and just postpone and delay.

From A Speech Before The Annual Members
Meeting Of The Federal Home Loan
Bank Of Pittsburgh, Hershey,
Pennsylvania, June 18, 1986

39.

Today, the ratio of reserves at the FSLIC to deposits in FSLIC-insured institutions is lower than ever.

Recapitalization of the FSLIC needs to genuinely provide sufficient resources to deal with the massive amounts of assistance required over the next five to six years to resolve cases, in order to put a large part of the FSLIC problem behind us.

But, FSLIC recapitalization will not be enough. To accompany recapitalization, there must be a heightened sense of awareness in the thrift industry of the need to prevent future excesses, the kinds of excesses which have led to many of the horrendous problems we now face.

To accompany recapitalization, **the Bank Board must have adequate supervisory and enforcement tools to deal quickly and effectively with the bad actors in the business so they are precluded from staying one step ahead of the regulator in the games they play.**

If we are to assume, as we must, that **the government itself** -- that is to say, **the taxpayer** -- ultimately stands behind the insured accounts at (thrift) institutions, then it seems to me the government has **both the right and the obligation** to spell out the **rules**, because insured institutions do operate on the full faith and credit of the United States.

If people (in the thrift industry) don't want to be subject to regulatory oversight for safety and soundness, if they don't want to play by -- and obey -- the rules as dictated by sound and prudent operating practices, particularly as set forth in the regulatory scheme, they can leave the thrift industry if they so choose.

(Some in the industry) believed that thrift deregulation meant there would be no more rulemaking. In the case of the savings institutions industry, **the regulator had no choice but to use the rulemaking process, because the real levels of net worth at far too many institutions were either low, or very low, or non-existent.**

...**We intend to stand up to those who would -- through their greed and irresponsibility -- threaten, and wreak further**

havoc on, the FSLIC, ultimately leaving the taxpayers of this country to pick up the bill.

There should not be a place or role in the thrift industry for the excessive risktakers, the go-go types, the high fliers and the crooks. This is a very serious matter.

From A Speech Before The Government
Relations Council Of The American
Bankers Association, Denver,
Colorado, July 30, 1986

40.

In the following, I want to bring you up to speed on the present and projected condition of the FSLIC fund in order to make sure you know from me the nature and magnitude of our problems.

As of today, there are 252 significant supervisory thrift institution problem cases which we project will require FSLIC assistance to resolve. These institutions are reporting $95 billion in assets.

The primary reserves of the FSLIC have dropped to $2.5 billion. Insured deposits in the nation's 3,249 FSLIC-insured savings institutions now exceed $800 billion. The ratio of the FSLIC's primary reserves to deposits held by FSLIC-insured thrifts has deteriorated steadily over the past few years to the all-time low of 0.31 percent. Given the FSLIC's caseload of severely troubled FSLIC-insured institutions -- currently 130 thrifts whose assets now total $47.6 billion -- that reserves-to-deposits ratio will continue to drop in the months to come as the FSLIC continues its efforts to resolve such cases in the most efficient manner possible, under the circumstances.

In addition to the 130 thrifts now in the FSLIC caseload, another 122 thrifts are projected to be added to that caseload in the next 12 months, more than half of them in the next 6 months. These 122 FSLIC-insured thrifts have assets of $47.3 billion.

The cost of resolving the 130 cases now in the FSLIC caseload is expected to range from $7-10 billion -- roughly three to four times the primary reserves now available to the insurance fund. Based on current projected plans for resolving FSLIC cases, the primary reserves of the fund will stand at $1 billion by the end of this year -- certainly a very thin margin by any standard.

Any delay in enactment of the legislation to recapitalize the FSLIC will further exacerbate the cost of resolution of severely troubled FSLIC-insured institutions because most all

of these very weak thrifts are paying excessively high rates to attract deposits to maintain liquidity. They are paying such rates because of their weakened condition and the public perception of a weakened FSLIC fund which insures deposits.

Because of the lack of reserves available to the FSLIC to resolve the magnitude of troubled cases before it, the Federal Home Loan Bank Board was forced last year to establish a management consignment program to stretch out case resolutions. Because of the growing scarcity of FSLIC resources, some 40 institutions have been placed in the program, in order to replace thrift management and determine as precisely as possible the nature and depth of losses. The extremely weak institutions which have been placed in the management consignment program are among the very highest ratepayers for funds in order to maintain their deposit bases. As a result of these high cost deposits, which most often fund poor quality assets yeilding little or no return, such institutions continue to experience large and worsening operating losses. During the second quarter of 1986 alone, institutions in the management consignment program lost approximately $700 million.

The longer action on such cases is deferred by the FSLIC -- because of inadequate resources to resolve them -- costs to the insurance fund will continue to mount, thus increasing the impact on those resources contemplated by the FSLIC recapitalization program.

The Bank Board estimated, and relayed information to the Congress some **five months ago**, that the cost of resolving severely troubled thrift cases over five years would approximate $16 billion. **This will continue to grow to the extent any final action by the Congress is delayed -- causing a significant number of case resolutions to be deferred even longer.**

As you know, the Bank Board's recapitalization plan contemplates up to $25 billion in funds over the next five years to deal with troubled FSLIC cases.

Delay can only further compound the FSLIC's problems, in every sense. The need to recapitalize the FSLIC, pursuant to the program the Bank Board has offered, is urgent. I know of no realistic or politically feasible alternative, short of an emergency appropriation by the Congress, itself. Such a course of action would, in my own view, make no sense at all, given the alternative the Bank Board and the Treasury have proposed.

From A Letter To Chairman Fernand
J. St Germain Of The House Banking
Committee From Chairman Edwin J. Gray
Of The Federal Home Loan Bank Board
September 17, 1986

41.

With the advent of the Garn-St Germain Act (of 1982) came a **new law** passed by the California legislature for state-chartered savings institutions. That law was **infinitely more liberal** than what Congress had passed. In effect, the California law allowed its state-chartered savings institutions to engage in **virtually any sort of activities they wished.**

The California legislature passed its **extremely liberal law** as an **incentive** for its state-chartered institutions...which had been moving to federal charters...**to stay state thrifts.**

With thrift deregulation came a far wider diversity of operating authorities on the asset side between various state-chartered thrifts and federally-chartered institutions. **The FSLIC was called upon to bear the risk of loss for this far more diverse variety of operating authorities.**

As the Bank Board moved into the fall of 1983, I became increasingly aware of, and indeed **alarmed** by, a developing change in the quality of assets in too many thrift institutions. **This trend was so striking that it raised in my mind very substantial cause for concern.** Too many thrift institutions -- in an effort to grow out of their portfolio maturity mismatch problems -- were growing at **lightning fast speed. At the time, we at the Bank Board had no mechanism for dealing with the fast deposit growth syndrome.**

And, **at the time, our examination and supervisory resources were simply incapable of keeping up** with the growing problems which were occurring at too many of our institutions.

Also note, the minimum net worth requirements for FSLIC-insured thrifts had been lowered from 5 percent to 3 percent between 1981 and the beginning of 1983. Further, a number of **accounting devices** (such as five-year averaging, 20-year phase in,deferred loan loss provisions, appraised equity capital, etc.) had been permitted to **distort** the calculation of net worth for regulatory purposes, in the 1981 and 1982 period.

This **compounded the problem I was faced with** because, again, lightning fast deposit growth was taking place on very low **levels** of real capital at too many institutions.

To get a handle on **the main source of deposit growth**, namely brokered money, the Bank Board joined with the FDIC in promulgating a joint regulation **intended...to restrict the flow** of third-party brokered deposits to FSLIC-insured institutions. It wasn't necessarily the best way to deal with the skyrocketing deposit growth, but it was the **only** vehicle **immediately available** at the time.

A few months after this regulation was adopted, **the federal judiciary ruled that the Bank Board and FDIC had exceeded their statutory authority.**

We had a situation where **the capital of the FSLIC was really the only capital on which highly risky activities were taking place** in too many institutions.

On March 6, 1984, I addressed the annual legislative conference of the U. S. League in Washington D.C. and said: "The **lightning fast growth**...we are witnessing can only exacerbate the problems of the FSLIC. **Incredibly fast deposit growth...(has) produced bad assets.** The ratio of FSLIC reserves -to-assets has **deteriorated steadily... (The fast growth we are seeing) leads me to the inescapable conclusion that (this) ratio will continue to drop...which will surely prompt imposition of additional (insurance) premium assessments**...which will be very costly to FSLIC-insured institutions...involving billions of dollars in additional assessments...in the future."

What I specifically warned about then has, unfortunately, come true. **Few in the thrift industry then wanted to hear those warnings. Many in and out of the thrift industry called my concerns sheer exaggerations.** Many urged me not to talk about such things. I was implored to make only positive statements. I refused. Needless to say, my repeated warnings were very unpopular.

If there are any here who see a merger of the FSLIC and FDIC as representing any kind of panacea for the problems facing the FSLIC, I would remind them that the costs associated with resolving the problem cases we know about ought to have the same effect as an ice cold shower on the merger idea.

I see no reason why commercial banks, as insurance premium payers, should be called upon to bear the cost of resolving thrift failures. A merger of the FSLIC and FDIC would, I fear, ultimately result in such a scenario...

Thrift deregulation has been misused and, indeed, severely abused by some savings and loan operators who, by their own actions, could apparently care less about the statutorily defined public policy purposes laid out by the Congress of the United States for savings institutions in the thrift system.

The thrift charter, a public charter, has been manhandled by some in the industry for purely personal gain. Excesses in **the absence of any prudence,** whatsoever, have been pursued by some in their **greed**, and by others who have suffered from **pure incompetence.**

The thrift system, and individual savings institutions themselves, have been chartered as **instrumentalities of public** policy. The federal deposit insurance guarantee was meant, from the very beginning, to serve no less than a high public policy purpose, where personal responsibility and prudence must govern behavior, and where fiduciary responsibility -- that is to say the wise and prudent use of other people's money -- ought to be the preeminent, driving force behind all operating practices and decisions.

Deregulation was never meant to relegate the regulator into oblivion, as some thrift executives had hoped. Paradoxically, the greater the deregulation, the greater is the role of the regulator to assure that the principles of safety and soundness and prudence and discipline are observed.

This will be true so long as publically-chartered depositories have the privilege of operating on the implicit full faith and credit of the United States, itself.

The taxpayers of this country, who ultimately stand behind the federal deposit insurance system, have every right to expect nothing less than a deep and continuing commitment by the managements of insured depository institutions to safe and sound and prudent operating practices.

The daredevils, the high rollers, those who have neither the expertise nor the management skills to run thrift institutions -- and, yes the crooks, driven by greed -- have cost, and will cost, the FSLIC billions of dollars in losses. What a terrible waste!

From A Speech Before The 1986 Annual
Convention Of The American
Bankers Association, San Francisco,
California, October 29, 1986

42.

The FSLIC is faced with unprecedented problems as the result of imprudent and, yes, egregious behavior by some in the industry who have chosen to misuse and abuse the thrift franchise out of sheer greed and purely personal gain.

Last year about this time, I told you the FSLIC would have to be recapitalized. It was not popular to say it. Some chose to disagree with me, claiming the insurance fund could work out its difficulties without any need for recapitalization (of the insurance fund). Well, it hasn't worked out that way.

It is my sworn duty under the law to try to carry out, as best I can, the expressed intent of federal law. The body of federal law which continues to govern the thrift system is replete in its message that the principal role of thrifts is, and ought to be, that of providing "economical home financing."

If the principal rationale for the continued existence of a separate thrift system were not spelled out in the statutes time and time again, it would be one thing. But, the fact is, the firm, contextual -- and yes, explicit -- justification for the separateness of the thrift system from the commercial banking apparatus rests on the commitment by savings institutions to the residential mortgage function.

This is not the only role required of thrift institutions insured by the FSLIC, to be sure. But, it is the principal role. **And there simply can be no mistaking it.** This is not to say that thrifts should be limited to making home mortgages and nothing else. The Garn-St Germain Act made that clear, and appropriately so.

Developments which have occurred in some states (have) sent a contradictory signal. There are instances in which some California state-chartered institutions have literally ignored any commitment, whatsoever, to the origination of residential mortgages.

Some state-chartered savings institutions have seen fit to fashion their role as essentially that of venture capital investment companies. They see their role as that of the speculator in real estate and other endeavors which have no conceivable relationship to what the Congress itself intended for thrifts.

Yes, the insurance carrier which guarantees the deposits they use to fund these wide-ranging investment company-oriented was established by the National Housing Act. To the extent they employ these FSLIC-guaranteed deposits in the acquisition of equity securities **which have nothing whatsoever to do with housing**, these investment company activities are **indistinguishable** from what we know as **money market mutual funds.**

Let me be clear. I have no brief against investment companies or money market mutual funds.

But, **when the residential mortgage finance function is, for all practical purposes, eliminated as a thrift function, in the name of thrift deregulation, the intent of the Congress for savings institutions, and the justification for a separate and distinct thrift system in America, is subverted at best and, at worst, is perverted beyond recognition.**

I have nothing but admiration for the true venture capitalist, the true entrepreneur, who invests his or her own money in all manner of endeavors. This is the stuff of which the American free enterprise system is made. The risk the true venture capitalist -- the true entrepreneurial investment company --

takes with its own money is not underwritten by the United States government. If such investments don't work out, if they go sour, the investment company entrepreneur in the role of venture capitalist may suffer financial loss. (Again) that loss is not underwritten by the government.

True venture capitalists do not operate their businesses on the full faith and credit of the United States.

Interestingly enough, we now have a **growing tendency** by **some** institutions in the **thrift** industry to **mimic the venture capitalist.** These "would-be" venture capitalists -- these mimics -- in the thrift industry, who somehow believe it is appropriate to run their entrepreneurial investment company and money market mutual fund operations on the thrift charter, and on the full faith and credit of the United States, are **not venture capitalists at all.**

To them, thrift deregulation means nothing more than a license to operate their investment company activities on the government's nickel, using federally-insured deposits as their source of funds.

In the name of thrift deregulation, they claim to be dedicated adherents to the "free market," and they cite the "free market" as their rationale for their activities -- even though they are not free market players at all.

They use their thrift charters, and the insurance of accounts they provide, as a **cash cow** for **other** purposes which, in many cases, have **nothing, whatsoever, to do with residential mortgage finance.**

As a matter of equity, I find this state of affairs troubling. Is it equitable for the thrift operator, who just happens to have a thrift license, to compete against other true venture capitalist investment firms in this manner?

If the purpose of the thrift charter today is to run such investment companies on the full faith and credit of the United States, then doesn't it logically follow that all investment companies -- and all other businesses for that matter -- ought to have the same right to a thrift charter, and insurance of accounts, to conduct their enterprises, irrespective of what these enterprises may be? They too could then go into the market for government-insured deposits and enjoy an unending source of money to conduct their operations. In this way, **as a matter of equity, all American investor-owned entities could share the privilege of conducting their enterprises on the government's nickel.** In this way, the government could pick up all the pieces, all the costs, if their enterprises were to fail.

I can find nothing in the statutes written by the Congress which even suggests, in the slightest way, that the purpose of the thrift charter was, or is, intended for venture

capitalists who want to run their non-thrift related investment companies on the full faith and credit of the United States. In my opinion, sound public policy simply does not, and cannot, justify the use of the thrift charter to achieve this end.

The thrift charter, a public charter, was intended by the Congress to serve as an instrument of public policy. That is why thrifts have been given the privilege of raising funds using the deposit guarantee. That is why thrifts are able to borrow at low cost from the Federal Home Loan Banks. That, indeed, is why there is, in fact, a separate and distinct thrift system whose principal purpose is to support the residential mortgage finance function.

The privilege of operating a federally-insured thrift institution is the equivalent of a public trust (since) thrift institutions are fiduciaries of other people's money -- (money) which is insured against loss by the United States.

Higher capital levels are the key to the survival of the thrift industry out into the future. And, higher capital levels are the key to the future of the FSLIC.

One of the most important accomplishments of the Bank Board in the last several years has been the strengthening of the regulatory oversight function, namely examination and supervision. Today, we have almost 1,500 examiners where, only 16 months ago, we had only 750. And, in little more than two years, we have tripled the size of our professional supervisory staff throughout the Federal Home Loan Bank districts.

It didn't happen all by itself. It has taken a great deal of effort, and frankly a great deal of courage, to bring it about. While it may not sound very sexy, **nothing I can think of will contribute more to the survival of the thrift system than the progress we have made in this area.**

In the final analysis, the defense of the resources of the FSLIC resides in the frontline examination and supervision functions.

I have fought long and hard for this system because I believe in it. However, **in the end, you in the industry hold the trump card. What you choose to be, and the purposes you choose to serve, will determine whether you have a separate and distinct system, and thus a separately identifiable thrift industry.**

In the final analysis, the regulator does not make laws. He or she is called about to carry out the intent of law, with the Congress overseeing that process.

Deregulation cannot work without the regulator.

The greater the deregulation, the greater is the responsibility of the regulator to assure that safety and soundness prevails, so long as you conduct your operations on the full faith and credit of the United States.

The Congress expects it, and the taxpayers have a right to expect it.

From A Speech Before The Annual Convention
Of The U. S. League of Savings
Institutions, San Francisco,
California, November 11, 1986

43.

The financial condition of...one fifth of the (thrift) industry is worsening steadily, creating increasing costs for the FSLIC. The longer we are forced to postpone the resolution of many of these cases, the greater will be the cost to the insurance fund.

There is no room...for any self-delusion today, for any reason.

Either recapitalization of the FSLIC moves forward -- and soon -- or I believe the future of the thrift system...will increasingly be put in jeopardy.

Pressures to effect a merger of the FSLIC and FDIC will mount gradually and inexorably unless action is taken by the Congress to permit the thrift insurance fund to be recapitalized.

These pressures will increase because, in my opinion, the Congress -- absent recapitalization of the FSLIC -- would seek at some time in the future the expediency of a merger, rather than an appropriation which federal taxpayers would be called upon to pay. Such a merger would constitute the beginning of the end of the nation's thrift system.

But, FSLIC recapitalization, itself -- in the absence of a strong commitment by the industry and the regulator to safe and sound operating practices, where prudence is observed, and a sense of discipline is adhered to by all; recapitalization of the insurance fund, in the absence of such a commitment -- simply cannot and will not succeed over time.

Our FSLIC recapitalization plan cannot succeed unless all parties recognize that excessive risktaking by insured institutions constitutes an ever-present threat, and that risktaking without adequate capital in the institution itself represents a clear and present danger to the reserves of the insurance fund, itself.

There have been some in this industry -- and yes, too many -- who, when deregulation was initiated by the Congress and by certain states, **wanted the regulator to go away**, and hoped the regulatory process would be **relegated to oblivion**. But, whether one likes it or not, **deregulation** -- if it is to be underwritten by the limited, finite reserves of the FSLIC -- **cannot and will not work successfully without the regulator.** Paradoxically, the greater the deregulation, the greater is the need for the regulator to assure that processes are in place to assure that safe and sound and prudent operating practices by insured institutions are fully and consistently observed.

In my opinion, **we would have far fewer FSLIC problems today had the Bank Board been given the people we needed to examine our institutions earlier on, when they were needed most.**

From the early months of my tenure, there has been a distinct unwillingness on the part of too many -- either in the (thrift) industry or in the Congress -- to acknowledge the gathering storm for the FSLIC, despite my repeated warnings in speech after speech to the industry, and in congressional hearing after congressional hearing.

Time after time, I warned about the pressures on the FSLIC, steadily deteriorating FSLIC reserves-to-deposits ratio, the worsening quality of the assets at troubled institutions, the need for additional FSLIC resources tp deal with the resolution of FSLIC cases, the need to pass legislation to strengthen the Bank Board's hand to protect the FSLIC, and indeed, since more than a year ago, the urgent need to recapitalize the insurance fund.

Frankly, too many in the industry were unhappy that I did issue these repeated warnings about the worsening condition of the FSLIC -- as though my not addressing them would somehow make the FSLIC problem just go away. I knew it wouldn't, and it surely hasn't.

A prime reason for the problems we confront today was, earlier on, the level to which minimum capital requirements had dropped -- from 5 percent in 1981 down to 3 percent in early 1983. I understand why the decisions were made then to drop the minimum net worth requirements (which included five-year averaging and 20-year phase-in) but the fact is -- no matter what the reasons -- the minimum net worth requirements (as they existed) were simply not sufficient to protect the FSLIC in the new deregulated operating environment (for thrifts) which was to follow. (These reduced net worth requirements) were so convoluted and distorted by various accounting treatments that (they) did not even begin to accurately portray the condition of FSLIC-insured thrifts.

My tenure at the Federal Home Loan Bank Board has been rather **controversial** in **some quarters.** **Nor could it, nor should it, have been** any **other way** because **the issues** involved -- yes the hand of cards I drew -- **made** this inevitable.

From A Speech Before The Annual Convention
Of The American League Of Savings
Institutions, San Diego, California
November 7, 1986

44.

We are now at **a very critical juncture** in the history of the Federal Home Loan Bank **System.** My concerns about the FSLIC, which I have expressed publically on **hundreds and hundreds** of occasions during my tenure (as Chairman of the Bank Board), are not exaggerations.

Without the FSLIC, there will not be a national thrift system as we (now) know it. Without the FSLIC, there will not be for long a separate thrift regulator. Without the FSLIC, there will not be for very long a separately identifiable thrift industry.

The FSLIC must be recapitalized. In my humble opinion, based on what I know at this time, **a pay-as-you-go recapitalization of the fund will not work.**

The stakes are so high for the future of the national thrift system that I would less than completely candid if I failed to emphasize here my complete disenchantment with the notion that any pay-as-you-go approach I'm aware of to recapitalize the fund could serve any truly useful purpose.

I urge the leadership of this most influential of all thrift trade organizations to face up squarely to the absolute necessity for the kind of recapitalization the Bank Board and Treasury proposed to the Congress this year.

Without the funding which recapitalization of the fund would provide, the Bank Board's **hands are tied.** **Meanwhile, expensive losses continue to pile up, the cost of money to the industry remains destructively high, and the ultimate cost to resolve FSLIC cases increases inexorably.**

I do not **see** any willingness by the Congress or the Administration **to bill such costs to the American taxpayers.**

Failure by all parties to face up to this critical challenge now, and deal with it straightforwardly, can only severely exacerbate efforts to keep the national thrift system together out into the future.

It is not predestined on high that the national thrift system will automatically endure. It will only endure if the savings institutions industry commits itself to principles -- and **mechanisms, such as effective FSLIC recapitalization -- which, themselves, enable the thrift system to endure.**

And, this means tough, sometimes rather unpleasant, decisions have to be made.

From A Speech Before U. S. League Of
Savings Institutions At Dinner
In Honor Of Joe C. Morris,
Chairman, Kansas City, Missouri
December 2, 1986

45.

In a very real sense, the Bank Board's principal mission is to serve as the Board of Governors of an insurance carrier -- the FSLIC.
Our sworn responsibility to the citizens of this country is to do our level best to protect the Federal Deposit Insurance System on their behalf. As operators of an insurance carrier, we are obliged, it seems to me, to take into account the risk of loss to the FSLIC from activities which are engaged in by insured thrift institutions, and to underwrite that risk as best we possibly can.

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The taxpayers of this country, the citizens of this country, have a right to expect that we, as public servants, will carry out our responsibilities as trustees of the FSLIC in a manner which best serves public interest.

We are not the property of the thrift industry, even though we do and should work very hard to facilitate industry health. More important, we are **servants of the public, including the American taxpayers**, who ultimately stand behind the insurance carrier we operate as a public trust. **We operate the FSLIC on behalf of the public**, citizens who, through their elected respresentatives, have chartered the national thrift system, including the FSLIC, as instrumentalities of public policy.

In all candor, if (the direct investment) regulation is not extended in a manner which can serve to communicate to the Congress the Bank Board's firm position on the direct investment issue, I intend to urge the Congress to tie this issue to passage of any FSLIC recapitalization legislation.

I say this because, as Chief Executive Officer of the FSLIC, given the losses the fund is experiencing, and will experience as a result of direct investments, recapitalization of the FSLIC would make little sense if future loss hemorrhages to the fund from such activities are not halted. **In the absence of any effective regulatory mechanism to prevent losses from**

misuse of direct investment authorities, I find it a vexing irony that I am at once responsible for the fund, but without adequate regulatory tools to protect it from substantial losses, and the high risk of loss, in the future.

I am a strong proponent of the direct investment rule. This is not because I believe it is nearly as strong as it should be, but rather because it stands as a symbol of the Board's resolve to protect the scarce reserves of the FSLIC fund. I believe the conceptual approach taken in the regulation is sound, even though it needs to be strengthened in my opinion.

From A Public Board Meeting Of The
Federal Home Loan Bank Board
On The Direct Investment Regulation,
Washington, December 18, 1986

46.

For a year and a half now, I have been saying the thrift insurance fund must be recapitalized. It became clear to me in the summer of 1985 that (the regular FSLIC insurance premium and the current maximum level of special assessments being imposed) would not be enough to maintain the level of reserves needed for the FSLIC to truly meet its obligations.

Today, the most severely troubled thrift institutions in our system are losing, on an operating basis, roughly $6 million a day or (at least) $2.2 billion a year. **This annual loss is more than the insurance fund's entire annual income and it's $350 more a year than the FSLIC is collecting in insurance premiums.**

During the past few years, the strains on the thrift system itself been enormous. **The system was not prepared to deal with the vicissitudes of a deregulated thrift operating environment.** The Bank Board has, I believe, made very considerable gains in its efforts to modernize and strengthen the regulatory oversight apparatus and process.

This progress must continue and must be further strengthened. Without the commitment and resolve necessary to ensure that safe and sound operating practices are **observed and enforced** throughout the thrift industry, and without the appropriate **discipline** necessary to assure that this does, in fact, occur, recapitalization of the thrift insurance fund, **no matter how much money it provides**, cannot truly succeed in reaching its intended goal -- that of getting the difficult problems that we now face behind us.

Last Spring (of 1986), I estimated the cost of resolving known cases requiring FSLIC assistance to be in the neighborhood of $16 billion. A good deal of work has gone into revision of last year's estimate and we now put the known cost at $19.5 billion. There are borderline cases, however, which I want to add to this estimate, which would bring the total to $23.5 billion.

I must emphasize these are estimates. No one can know with any certainty in advance what the actual cost of resolution to the FSLIC will be over time. **The overall plan to recapitalize the thrift insurance fund which we have proposed contemplates, if necessary, as much as $32.5 billion for resolving terminally-ill thrift cases over the next seven years.**

In my view, the Bank Board-Treasury recapitalization plan, though not perfect -- but what is? -- is far superior to any other plan of which I am aware.

Regulatory intitiatives to assure safety and soundness are often controversial in the thrift industry. **Some members of the Congress sometimes bring substantial pressure to bear on regulators to relax, or even withdraw, regulatory initiatives** intended to strengthen safety and soundness in the thrift industry. In my opinion, what they (members of Congress) ought to be saying to us is: "You take the heat. We'll back you up. Do what you have to do to make the system work."

In my role as regulator, I have not pandered to the industry, and most particularly to the high risktakers, the high rollers, the daredevils. On the contrary, I have sought, with some considerable opposition at times, to put in place rules which I have believed would **lessen the risk of loss to the insurance fund, without unduly restricting sound opportunities for thrift institution profitability.**

From Testimony Before The Senate
Banking Committee, Washington
January 21, 1987

47.

At a time when we are talking about the state of affairs which has brought us to the critical issue of FSLIC recapitalization, this is no time to temporize on the direct investment issue. In my mind, **the recapitalization of the thrift fund makes little sense if we fail to deal with the direct investment issue**, and its impact on the reserves of the FSLIC.

Without appropriate **discipline** in the thrift industry, and a recognition on the part of everyone that safe and sound thrift operations are the key to the thrift industry's future, **any**

plan to recapitalize the thrift insurance fund can only end in ultimate failure.

Call it "re-regulation" if one feels compelled to do so, but there is no substitute for safety and soundness if recapitalization of the thrift insurance fund is to be effective in both the short and long term. Hence the need for greater regulatory discipline.

Recapitalization is not a panacea, but simply the first step to restoring the FSLIC to long-term viability.

The FSLIC fund now has a **much lower** ratio of reserves-to-deposits than the Ohio and Maryland funds had immediately prior to their collapse. Without recapitalization, the fund will continue to decline.

All of us are aware of the terrible price inflicted on depositors, commerce and taxpayers by the Ohio and Maryland thrift failures. Those crises also created political crises that still reverberate in both states.

We can avoid that calamity if we act responsibly and decisively how to put the FSLIC-Treasury recapitalization plan into operation. Those who would engage in **continued brinksmanship** with the solvency of the FSLIC fund are risking disaster.

From Testimony Before The House
Banking Committee, Washington
January 22, 1987

48.

The primary reserve of the FSLIC fund (is) now $1.4 billion. (It) has approximately $3.7 billion in cash and investment securities on hand.

FSLIC receiverships hold approximately $7.1 billion in assets. Approximately 50 percent of these assets are located in Texas. FSLIC is by far the largest creditor of such receiverships.

Prompt recapitalization of the FSLIC through the full Treasury-Bank Board plan is essential.

From Chairman Edwin J. Gray,
Chairman Federal House Loan Bank Board,
To Senator William Proxmire,
Chairman, Senate Banking Committee
March 2, 1987

49.

I cannot support the...proposal to allow thrifts to amortize qualified loan losses over 5 to 10 years.

Bad accounting drives bad decisionmaking. Amortization could delay, sometimes for years, the Bank Board's ability to take effective action against a thrift that was, in fact, hopelessly insolvent, but was reporting positive regulatory capital because amortization delayed recognition of those losses.

Moreover, the Bank Board's experience is that markets are not easily fooled by relative regulatory accounting principles. Indeed, we believe that markets react adversely to **cooked books**, and increase the cost of capital to industries employing such techniques.

The Bank Board and the thrift industry fell into disrepute with the Congress, investors, the accounting profession, and other financial institutions when my predecessors embraced creative regulatory accounting principles.

We cannot survive a continuation, much less an increase, in accounting principles that **hide the true financial condition** of thrifts. Worse, like price subsidies, phony accounting is **addictive.**

My experience at the Bank Board in trying to **wean** thrifts from their addiction to creative regulatory accounting principles has taught me **how difficult it is for a thrift to go "cold turkey"** and report its **true** financial condition after years of reporting an artifically inflated net worth.

From A Letter to Congressman Steve
Bartlett of Texas From Chairman
Edwin J. Gray of The Federal Home
Loan Bank Board, March 2, 1987

50.

The Bank Board will continue to take vigorous action to reduce problems that are the the result of **fraud, insider abuse or incompetence.**

However, the Board will continue to work with savings and loans whos problems are primarily the result of inadequate capaital and temporarily depressed regional economies.

I cannot support the...proposal to allow thrifts to amortize qualified loan losses over 5 to 10 years. This would be improper under generally accepted accounting principles. The effect is to allow an institution to fail to report currently its losses when calculating its regulatory capital requirement. **The resulting financial statements could mislead the public. GAAP forbids such loan loss amortization because** it **causes** an inaccurate report of the current financial condition of the institution. I know you share my belief that **it is contrary to public policy to mislead the depositing and investing public.**

I inherited a system that had many non-GAAP accounting provisions that could **mislead** the public by **overstating** the true financial condition of thrifts. I have successfully led the fight to abolish many of these **so-called** regulatory accounting principles. **I am firmly opposed to "cooking the books."**

From A Letter to Congressman Fernand J.
St Germain, Chairman, House Banking
Committee, From Chairman Edwin J.
Gray of the Federal Home Loan Bank
Board, March 2, 1987

51.

The General Accounting Office (GAO), the auditor designated by ...Congress to audit the books of the FSLIC, has determined that the insurance fund was insolvent at the end of 1986 by over $3 billion, using GAAP (and) is **even more insolvent today.** Within the next month or so, based on anticipated expenses, the fund may be insolvent by **over $4 billion,** on a GAAP basis.

FSLIC's liquidity has been significantly reduced. We currently have apaproximately $3.7 billion in cash and investment securities. Within a month or so, that liquidity may well be much closer to $2 billion, based on anticipated expenses. **This is untenable.** Moreover, there are severe constraints on FSLIC's ability to draw upon other sources of liquidity.

(Also) FSLIC must have the capability to resolve problems. **This requires that the FSLIC maintain funds sufficient to resolve problems, not simply liquidity.**

I have been consistently candid with Congress about the problems besetting the FSLIC, and the urgent need to recapitalize the fund. For this I have been criticized by many in the industry.

Your own GAO auditors have been strongly criticized because of their candid reports to the Congress.

Some claim there would not be a problem if the GAO and I were to simply stop talking about it -- as though by not addressing it, the problem would go away. I have never sought to hide

the facts from, or to mislead, the Congress. I do not intend to do so now.

In my own view, which I respectfully offer, the adoption of plans involving lesser resources (ie. $5 billion,$7 billion) **would be tantamount to the adoption of a continuing crisis resolution. No one has demonstrated that such sums are even remotely adequate to meet the full magnitude of the FSLIC's problems.** (This was in reference to the $5 billion House bill and $7.5 billion Senate bill, compared to the $15 billion proposal by the Bank Board to recapitalize the FSLIC.)

There are tremendous costs to the FSLIC from delay in closing hopelessly insolvent thrifts. Time cannot heal the wounds of such thrifts.

In my opinion, the systemic and individualized attempts to prevent the Bank Board from resolving such hopelessly insolvent thrift cases must stop. No rational regulatory system or insurance fund can survive if efforts to **undermine** its effectiveness and credibility are allowed to succeed.

Congress criticized us sternly for not being sufficiently firm in preventing unlawful and unsafe practices in the Dallas district. Roy Green and Joe Selby of the Federal Home Loan Bank of Dallas are under slanderous attack because they are doing their duty as regulators.

I have made clear **many times**, in testimony before the Congress and in numerous speeches to industry groups, that **constraints on FSLIC by the Office of Management and Budget (OMB) and the Office of Personnel Management (OPM) have severely impaired our ability to attract and maintain the numbers and quality of FSLIC staff we need to accomplish these goals.**

The response to our critical needs in this regard has been **thoroughly inadequate**. FSLIC has had to handle the liquidation of assets of approximately the same dollar amount as the FDIC, with a staff that has scores of people. FDIC is not under the same **crippling** staffing and salary constraints imposed on the Bank Board and FSLIC by OMB and OPM.

Further delay in passing the Bank Board-Treasury recapitalization plan is **unwarranted**. **Further delay...is dangerous**. Prompt action by Congress assuring that the FSLIC fund will, indeed, be adequately recapitalized over the next five to seven years is today's necessity if we are to maintain and restore confidence in the thrift system and the FSLIC.

From A Letter To Congressman Fernand J.
St Germain, Chairman, House Banking
Committee, from Chairman Edwin J.
Gray of the Federal Home Loan Bank
Bank Board, March 9, 1987

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ADDENDUM A

February 3, 1986

Ms. Carol Crawford
Associate Director for Economics
and Government
Office of Management and Budget
The Old Executive Office Building
Washington, DC 20503

Dear Carol,

This describes the significant disparities in employment compensation and benefits between the Bank Board and Federal Reserve Board (FRB), Federal Deposit Insurance Corporation (FDIC), and the Comptroller of the Currency (OCC).

The FRB, FDIC, and OCC have enjoyed for years a range of compensation and benefit flexibilities beyond the reach of Bank Board staff. The flexibilities enable these other agencies to offer an employment package comparable in large part to the kind found in many private sector enterprises. As a result, the Bank Board has been at a severe double disadvantage in competing for the top talent in the financial industry arena.

The key to these agencies' flexibilities is their exemption from the Classification Act, an exemption rooted in their enabling legislation. Although they generally follow the salary grades and pay ranges of the Classification Act (GS-1-15), the FRB, FDIC, and CCC have the freedom to fix the compensation of their employees and to provide salary enhancements and benefit programs that they deem appropriate. The Bank Board, on the other hand, is restricted from any such independence due to OPM's interpretation (dated August 7, 1957) that our agency is subject to the provisions of the Classification Act.

In terms of basic compensation, the Bank Board can offer an applicant only the minimum salary level of a grade whereas the other financial regulatory agencies can exceed the minimum level. For example, in filling a senior financial analyst position, the Bank Board could offer a candidate with exceptional related experience a starting salary of only $37,599 (step 1 of the GS-13 range); the other agencies could offer $48,876 (step 10 or the maximum rate of the GS-13 range)--a starting difference of $11,277. In setting the grade limits of particular occupations, the Bank Board is restricted to the criteria of classification standards published by OPM (in many cases 15 to 20 years ago) while the other agencies can determine the value of their occupations according to current industry conditions. Furthermore, in promoting individual employees, the Bank Board is restricted to narrowly defined increases rather than to levels commensurate with employees' contributions.

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The Bank Board suffers further disadvantages with regard to compensation enhancements. The FDIC, for example, annually grants each of its employees a regional pay differential over and above any governmentwide cost of living adjustment. The differential varies from year to year and from one geographic region to another, but all FDIC employees in 1985 received between approximately 2 percent to 10 percent in addition to their base compensation. In 1986, when all federal employees (including Bank Board staff) are receiving no salary adjustment, FDIC employees are receiving an increase between 7 percent to 20 percent on top of their base pay.

Another disparity of this kind exists regarding bonuses. The FRB can grant a bonus to all of its officers each year for superior performance, and the OCC has a salary increment program in which its superior professional employees can receive an increment between 2 percent and 14 percent of their basic pay. In contrast, OPM regulations governing Senior Executive Service (SES) performance bonuses restrict cash awards to 30 percent to 35 percent of the Bank Board's career SES staff. Under a liberal OPM interpretation of these regulations in 1985, we were permitted to grant bonuses to only three of our career SES employees. Similarly, Bank Board mid-level managers and supervisors were restricted to performance awards of between 2 percent to 3 percent of basic pay given the limitations imposed by OPM regulations on employees subject to Merit Pay regulations.

If the advantages enjoyed by the FRB, FDIC, and OCC in determining direct compensation and salary enhancements were not enough of a disparity, these agencies also provide benefit programs far more liberal than standard government benefit programs available at the Bank Board. Employees in these agencies can choose life insurance and health programs (including dental and vision options) at no cost, or at very limited costs.

Among these three agencies, the highest cost for life insurance is 7 cents biweekly for $1,000 of basic coverage (FRB) whereas Bank Board employees pay 20 cents biweekly for $1,000 of basic coverage. The cost disparity in health coverage is even more striking. The highest cost for Blue Cross-Blue Shield maximum family coverage among these other agencies is $20.64 biweekly (FRB) where parallel coverage for government Blue Cross-Blue Shield is $66.13 biweekly.

In addition, both the FRB and the FDIC offer employer-subsidized savings instruments for their employees. The FRB has both a thrift plan and a 401K plan in which the FRB will match 60 cents for every dollar contributed by an employee into these plans (up to a total of 6 percent). The FDIC provides a 401K plan in which it matches dollar for dollar of employee contributions up to a total of 5 percent. The OCC has developed a thrift plan but is awaiting final approval from the Treasury Department. The Bank

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Board, like other federal agencies, has neither a thrift plan nor 401K plan available for its employees.

Attachment 1 summarizes the benefit comparisons between the Bank Board and these other agencies. We believe it is obvious that the playing field is far from level and that the Bank Board is at a severe disadvantage in trying to compete for the best talent in the marketplace. As long as the restrictions of the Classification Act, the Senior Executive Service, and Merit Pay continue to apply, these disadvantages will continue and intensify.

To illustrate the impact of these disparities on our recruitment and retention capability, we are providing you with specific case examples in attachment 2. We hear these problems cited continuously by our managers and supervisors.

In light of the disparities we have described above and their impact on our ability to recruit and retain talented staff, we continue to be in dire need of relief from several civil service provisions. First, or course, is relief from the Classification Act itself. We have earlier provided you with the last correspondence between the Civil Service Commission (now OPM) and the Bank Board regarding our arguments that this agency is not covered by the Classification Act provisions. It is clear that OPM has the authority to interpret the coverage provisions of the Classification Act and to exempt agencies if they fall within the statutory list of exemptions. Attachment 3 represents the legal argument we have developed in support of an exemption. We believe that OPM should recognize our authority to fix the compensation of our employees.

Second, we need relief from the provisions of Merit Pay and the Senior Executive Service. To obtain an exemption from the Classification Act without comparable flexibility for our senior staff (SES or Merit Pay) would frustrate our basic effort to achieve equity.

Third, we also need the flexibility to offer benefit programs similar to those at the FRB, FDIC, and OCC. We believe the authority to establish such benefits would be implicit in an exemption from the Classification Act but, if not, we are seeking separate authorization to do so. Even if OPM maintained its position that the Bank Board is subject to the Classification Act, we would still need the authority to offer these benefit enhancements as a partial solution to our problems.

As a final request, if OPM does not decide to exempt our agency from the Classification Act, we seek approval to establish special pay rates for our occupational series most severely affected by the compensation disparities cited above. This relief, of course, is a last fallback position from the first

52.

As we indicated in our **testimony before** you in **1985**, the FSLIC fund was then in need of recapitalization. **From early on in my tenure at the Federal Home Loan Bank Board, I have sought to keep the Congress and the thrift industry apprised of the weakening condition of the insurance fund, including the steadily deteriorating reserves of the fund, and the declining ratio of FSLIC reserves-to-deposits.**

Many in the thrift industry have, over the course of my time in office, admonished me not to talk about the fund's weakening condition, **apparently in hopes that by sweeping the problem under the rug it would somehow go away. Indeed, I have warned repeatedly since late in 1983 of my deep concerns about the worsening condition of the thrift fund.**

Unfortunately, even though the (Bank Board's FSLIC recapitalization) plan requires no public funds...and reduces the burden on the (thrift) industry, we cannot implement the plan until Congress acts.

We have done everything we can. We have already raised our (insurance premiums) to the maximum extent allowable under law. We have brought the problem, and a viable solution to Congress' attention in the most forceful means possible. Congress, however, has not authorized us to restore the FSLIC's insolvency.

As we warned, the GAO has found the FSLIC was insolvent (under generally accepted accounting principles) by billions of dollars as of December 31, 1986. FSLIC has become even more insolvent since then. **Some people say that the FSLIC is only "technically" insolvent. I do not know what that means.** I do know that the FSLIC's insolvency has imposed, and will impose, real costs to the FSLIC and the thrift industry.

The FSLIC's insolvency is likely to end any significant Federal Home Loan Bank (FHLB) loans to troubled institutions that lack sufficient collateral support them. This will increase the already ruinously high net operating losses at such problem institutions and force their healthier competitors to raise their deposit rates and (therefore) cut their profitability.

The cost of resolving the FSLIC's problems has increased substantially because of delay. The net operating losses of institutions in our Significant Supervisory Caseload have increased from approximately $6 million per day (over $2 billion a year) in mid-1986 to approximately $10.4 million a day ($3.8 billion a year) by the end of 1986.

These net operating losses are running **double** what the FSLIC's entire annual insurance premiums bring in.

The failure to allow the FSLIC to recapitalize in 1986 has already cost the FSLIC, and may cost the taxpayers, well over $1 billion. The incremental cost will exceed at least $2 billion by the time recapitalization is authorized this year. Like interest on the national debt, this cost grows exponentially with delay in resolving the underlying problem.

(And) Delay in allowing FSLIC to recapitalize...has created an enormous incentive among weak thrifts to engage in investments that will produce **future losses** for the FSLIC, while impeding our ability to move aggressively against these institutions.

Delay also harms the entire (thrift) industry. Deeply troubled savings and loans must offer very high interest rates to maintain their deposit bases and avoid liquidity problems. This pushes up the cost of all institutions' cost of funds.

Not only has Congress failed to act to allow the FSLIC to recapitalize, but its actions in this session threaten to increase the cost to the FSLIC and the taxpayers.

The Senate has passed a bill which would allow the FSLIC to raise bond revenues of only $7.5 billion. The bill reported out of the House Banking Commmittee would limit the FSLIC to raising only $5 billion (as favored by the U. S. League of Savings Institutions).

No one believes that either plan provides remotely enough money to allow the FSLIC to resolve problems and restore its financial health, especially in light of FSLIC's current insolvency.

A serious problem with the House Banking Committee bill is its "forbearance" provisions. Forbearance does not mean (or shouldn't mean) **hiding the true financial condition** of an institution from the public and the regulator. We must know the truth. Only then can we rationally decide whether forbearance is proper. Rational forbearance, as a subset of regulation and effective supervision, can only exist where there is a foundation of accurate accounting.

The record of my tenure as Chairman cleary demonstrates a Board that has moved towards more accurate accounting in order to avoid the artificial boosting of net worth by others.

In the context of the (FSLIC) recapitalization debate, the principle of public responsibility grounded in accurate reporting has been swept aside by a tide of opponents increadibly brazen in their support for accounting gimmickry.

(A) constraint...on the FSLIC's ability to minimize losses...is **lack of experienced staff** at the Bank Board. Because of OMB (Office of Management and Budget) and OPM (Office of Personnel Management) personnel and pay caps, which our sister financial regulators are **not subject to, we have a small fraction of the staff, at lower rates of compensation, than the FDIC.**

Yet, **the magnitude of our problem (at the FSLIC), even in absolute dollars, is approximately the same size as the FDIC's.** Mr. Chairman (Dingell), we know that you have long recognized and appreciated this problem. In hearings before this Subcommittee on July 19, 1985, you said to me: "I want you to know that in your difficulties with the Office of Management and Budget, you have the full sympathy and support of this committee. **I think the fact that they don't give you enough examiners, and the fact they don't let you pay them enough, is a national disgrace**, and jeopardizes the security of our financial system."

Mr. Chairman, **it was a disgrace.** It did jeopardize the security of our financial system. The federal commercial banking regulatory agencies are not subject to those OMB and OPM limits. They have vastly larger staffs. They can pay their employees much more than the FSLIC can. Naturally, they can retain a far more experienced staff with far lower turnover.

Despite our repeated requests, Congress has not provided equal treatment for the FSLIC with our sister agencies. The FSLIC's staffing limitations, therefore, continue. It was inevitable that such arbitrary personnel limits would ultimately exacerbate losses to the FSLIC.

The worst managed thrifts now routinely seek political intervention to prevent the kind of vigorous supervision (that is) vital to protect depositors. The attempts to intimidate the Bank Board are not even concealed. One key aide threatened publically that I could end up "sleeping on a grate" because I voted to appoint a receiver for one institution destroyed by insider abuse.

I find all of this nothing short of unconscionable. **I would never have believed that, despite advance warnings, Congress would fail to allow the FSLIC to recapitalize itself, leaving the fund deeply insolvent and virtually out of cash. I certainly would not have believed that even after allowing this to happen nok prompt congressional action would come.** Most inconceivable, however, is that Congress would propose legislation that is designed by some industry proponents to make the problem worse.

In private, some industry leaders make **no secret** of what they are attempting to accomplish. **They want the taxpayers to pay**

the cost of resolving failed thrifts. Their goal is a $5 billion, two-year recapitalization plan that will allow the FSLIC to exist for two years, albeit in a state of continuing crisis.

After two years of inadequate funding, problems would have increased to a magnitude that no recapitalization will be possible without taxpayer support. **A new administration would then be forced to support a taxpayer bailout of the thrift industry (insurance fund).**

Some industry leaders opposing our recapitalization plan did not, however, have the political muscle to block it. Therefore, by one leader's own description to us, they struck a **"Faustian bargain"** with a much smaller group, but one with vast political power.

This latter group does not **simply** wish a taxpayer bailout. *It* **wants an end to effective government supervision against unsafe and unsound practices and insider abuse.**

Some in the (thrift) industry embraced loan loss amortization as part of their Faustian bargain. Attacks have been unleashed on the GAO. When GAO, following GAAP (generally accepted accounting principles), reported that the FSLIC was insolvent, a top industry leader called reports that the FSLIC was insolvent "outrageous."

He charged that the GAO was manufacturing a "bookkeeping crisis" to pressure Congress into passing (what he called) "an excessively large" FSLIC recapitalization program.

This **"shoot the messenger"** type of response, combined with disparagement of the entire concept of proper GAAP disclosures of the FSLIC's condition, is deeply troubling, and runs directly counter to the goals of **accurate reporting**, shared by this committee and the Bank Board.

The assault on our efforts to supervise problem institutions and stop unsafe and unsound practices and insider abuse is the most indefensible element of the Faustian bargain. As this Subcommittee knows...the FSLIC has suffered massive losses from such practices and abuses.

We have taken aggressive measures to prevent a recurrence of such losses.

In the face of virulent resistence, the Bank Board (has) attacked (many) perverse incentives during my tenure. We eliminated 20-year (phase-in) and 5-year averaging. We adopted a capital regulation to move the industry gradually to a six percent capital standard. Moreover, our capital regulation contains variable capital requirements that create **strong incentives to reduce credit and interest rate risk.**

(Our efforts) have made a major difference. Imprudent practices and losses are detected at an earlier point. Our regulatory measures prevent many imprudent practices from occurring.

The success of our efforts is perhaps best evidenced by the wave of criticism of our supervisory efforts for allegedly being **too tough.**

We are under massive political attack precisely because we have taken the actions this Subcommittee urged us to to undertake -- tough supervision.

Meanwhile, a **myth** is being propagated. The myth is that the problems facing the FSLIC are overwhelmingly due to temporarily **distressed** regional economies. We are urged to do nothing and let time heal the wounds.

The truth is very different. The massive losses facing the FSLIC, even in Texas, were caused by thrift managers who were reckless, or worse.

Instead of receiving promptly the authority to prevent FSLIC's insolvency, we have been met by inaction (even though) the FSLIC is insolvent, with less than a billion dollars in cash. Its embedded losses are growing rapidly.

FSLIC insurance was designed to protect depositors. I now see it being perverted into a system designed to protect, yes shield, officers and owners of thrifts from economic loss, even at the cost of a taxpayer bailout in the future.

From Testimony Before The Subcommittee
On Oversight And Investigations
Of The House Energy And Commerce
Committee, Washington, April 23, 1987

53.

During these past four years of my tenure as Chairman of the agency, I have had to deal with a formidable array of problems. I recognized early on, **when it was unpopular to believe, or even say**, that thrift deregulation -- as thrift deregulation was interpreted by many in and out of the industry -- was on **a collision course** with the safety and soundness of the FSLIC.

I said it. I believed it. And, I set about **in the face of opposition from many in and out of the government** to face up to that challenge.

The sad fact is that thrift deregulation was thrust upon a regulatory apparatus that was neither designed nor equipped to

deal effectively with the result. Further, many in the (thrift) industry itself believed, and some still do, that thrift deregulation was intended to consign the regulator to oblivion. Some in the government apparently also subscribed to that notion.

At a terribly critical time, in the first several years or so of thrift deregulation (post Garn-St Germain), OMB (Office of Management and Budget) **repeatedly denied** my request for more examination personnel.

The Bank Board finally took **matters** into **its** own **hands**, and **(still)** in **the face of** OMB **opposition, we took the** ultimate **step of** simply **removing the examination function** from OMB's jurisdiction.

If there had been a recognition, as there ought to have been, by **all parties, including the Congress**, that without adequate regulatory tools, and without sufficient well-trained personnel to examine and supervise enterprises operating on the government's guarantee, the scarce resources of the FSLIC would (indeed) be endangered. **If there had been such recognition earlier on, we might not be facing the current problem at the FSLIC.**

Some of the same difficulties we faced (earlier) continue. We are not treated in the same manner as our commercial banking regulatory colleagues.

Bank Board/FSLIC employee salary levels are set by the Office of Personnel Management (this is **not** the case for the Federal Reserve Board, the FDIC and the Comptroller of the Currency).

The average annual salary of our 192 professional staffers at the FSLIC is only $35,000. The turnover rate is running at 26 percent annually. (Our sister commercial bank regulatory agencies) enjoy the luxury of an upper-end compaction problem. I wish to God we could have such a "problem."

I have sought legislation from the beginning of my tenure to make the Bank Board a mixed government corporation so that our Bank Board/FSLIC employees would be treated in the same manner as the employees of the FDIC.

In my opinion, one of the things the Congress could do to help our agency would be to place us on a level playing field with the FDIC. We have a small fraction of the staff available to the FDIC, and at lower rates of compensation. Yet the magnitude of the problem (both agencies face) in absolute dollars is approximately the same as the FDIC's.

From Testimony Before The HUD-
Independent Agencies Subcommittee
Of The Senate Appropriations
Committee, Washington
April 24, 1987

54.

(Because of the insolvency of the FSLIC) we have been forced to shut down our resolutions of hopelessly insolvent institutions. (This) inability...can only **increase** net operating losses among troubled thrifts. **These losses are now running nearly $4 billion a year -- and climbing.**

The FSLIC will have to deal with such losses. **Delays in resolving cases, for whatever reason, can only increase FSLIC losses.**

The longer hopelessly insolvent institutions stay open, the higher the costs to the FSLIC and, indeed, to other financial institutions, especially thrifts. Not only are net operating losses running at around $4 billion a year, but the industry also is paying a very heavy premium for deposits -- at least $4 billion annually because of the perceptions of a weak fund and hundreds of weak institutions.

The other deep concern I have about the House FSLIC recapitalization bill is its so-called forbearance features which **appear to have been designed to protect savings and loan operators** -- irrespective of the financial condition of the thrifts they run.

This is a far cry from the original intent of deposit insurance, which is and has been for a half century to protect depositors (not savings and loan operators and their investments).

Frankly, the so-called forbearance provisions in the (House) bill are a **travesty. I fail to see what conceivable...public policy purpose they could serve, other than to protect savings and loan operators**, **running hopelessly insolvent thrifts, from losing their positions.**

Whatever happened to the concept that federally-insured depository institutions be operated in a safe and sound manner, **and in the public interest? Who are we protecting? Whom should we be protecting?**

I respectfully submit we should be protecting depositors, and yes the taxpayers, but not the operators of hopelessly insolvent thrifts.

Indeed, were these atrocious forbearance provisions to survive conference (committee) and be enacted into law, the end result would be losses far more massive than those we know about today.

Again, they would be entirely unecessary losses which American taxpayers ultimately would be called upon to bear -- unnecessarily.

I want to emphasize that for virtually my entire tenure on the Bank Board I have sought legislative authority to remove FSLIC from the control of OMB and The Office of Personnel Management. An apparent accident of history places the FSLIC directly under the thumb of OMB and OPM.

In 1984 and 1985 I proposed to the Congress that the FSLIC be made a "mixed government corporation," precisely the legal designation of the FDIC.

So long as the FSLIC remains under OMB's budget constraints and under OPM's salary-setting constraints, the Bank Board will have severe and entirely unnecessary problems in staffing FSLIC and paying salaries that make sense. Our sister insurer -- the FDIC -- is not so burdened. Nor should we be.

From Testimony Before The Subcommittee
On General Oversight and
Investigations Of The House
Banking Committee, Washington,
May 14, 1987

55.

I have sought from the beginning to be candid and straightforward with you about the industry I regulate (and) my concerns over time about the deteriorating condition of the FSLIC.

I have been a much tougher regulator than many in the thrift industry would have liked.

There is, and has been, a fashionable notion that thrift regulators ought to be go-along guys who either keep their mouths shut about problems or operate as good news charlies, limiting their public -- and even private -- utterances to only positives and never negatives.

As a thrift regulator, I have not chosen to be a go-along guy -- a good ole boy -- or a good news charlie.

I've sought very hard to be a regulator -- which is what I believe the Congress, and certainly the law, want me to be --

not an industry spokesman or an extension of any thrift trade association.

I am not, nor have I been, the property of the institutions I regulate, nor should I be. Some in the thrift industry have considered the Bank Board as their property and, by damned, the regulator had better go along with them if he knows what's good for him. This is an unhealthy notion, for the industry and for the government.

Had I chosen to be popular with the industry I regulate, I would have done virtually nothing in these last four years except to maintain the status quo which existed when I took office. Think about the consequences of that course of non-action.

The role of the thrift regulator must necessarily be that of -- **yes -- a regulator**. And the thrift regulator must stand up to **enormous pressures** if he or she is to carry out his or her duties to protect the public interest.

I have taken many regulatory actions which have not been, and are not, popular with some I regulate. But, I have not seen my role as that of running a popularity contest.

The effects of OMB's intransigence with respect to not providing the kind of help we needed , and repeatedly requested, have been adverse in the extreme.

The best thing you could do for the Bank Board, the thrift industry, and this (Federal Home Loan Bank) system in the years to come would be to **eliminate** the constraints imposed upon us by OMB and OPM, and make us just like the FDIC.

The best thing you could bequeath to my successor would be precisely that. Because the longer we are under these kinds of constraints, the more difficult it's going to be for my successors to deal with the kinds of problems that we have had.

From Testimony Before The Senate
Banking Committee, Washington
May 21, 1987

56.

We need to concentrate the efforts of Congress and the Bank Board on restoring the solvency of the FSLIC fund and ensuring its long-term viability by **strengthening, not weakening**, our supervisory powers.

We also need to work **to keep the taxpayers from getting stuck with the tab** if the richest thrifts exit the FSLIC system, leaving the burden with those who remain (including the taxpayers), thus making any fully industry-based recapitalization untenable.

From Testimony Before The Subcommittee
On General Oversight And
Investigations Of The House
Banking Committee, Washington
June 17, 1987

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three requests because it allows us only to relieve the problems in certain parts of the organization with respect to basic pay.

In my opinion, perpetuation of the disparities and relative inequities which exist today--and have given this agency unnecessary grief for too long a time--works to the detriment of a sound national thrift institutions system.

I wish you success in bringing to the attention of OPM the clear and compelling--and yes, urgent--need for change in order to eliminate the unjustified disparities I have outlined above.

Sincerely,

s/ Edwin J. Gray

Edwin J. Gray
Chairman

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February 18, 1986

Honorable Constance Horner
Director
Office of Personnel Management
1900 E Street, N.W.
Washington, DC 20415

Dear Connie:

This describes the significant disparities in employment compensation and benefits between the Bank Board and the Federal Reserve Board (FRB), Federal Deposit Insurance Corporation (FDIC), and the Comptroller of the Currency (OCC).

The FRB, FDIC, and OCC have enjoyed for years a range of compensation and benefit flexibilities beyond the reach of Bank Board staff. The flexibilities enable these other agencies to offer an employment package comparable in large part to the kind found in many private sector enterprises. As a result, the Bank Board has been at a severe double disadvantage in competing for the top talent in the financial industry arena.

The key to these agencies' flexibilities is their exemption from the Classification Act, an exemption rooted in their enabling legislation. Although they generally follow the salary grades and pay ranges of the Classification Act (GS-1-15), the FRB, FDIC, and OCC have the freedom to fix the compensation of their employees and to provide salary enhancements and benefit programs that they deem appropriate. The Bank Board, on the other hand, is restricted from any such independence due to OPM's interpretation (dated August 7, 1957) that our agency is subject to the provisions of the Classification Act.

In terms of basic compensation, the Bank Board can offer an applicant only the minimum salary level of a grade whereas the other financial regulatory agencies can exceed the minimum level. For example, in filling a senior financial analyst position, the Bank Board could offer a candidate with exceptional related experience a starting salary of only $37,599 (step 1 of the GS-13 range); the other agencies could offer $48,876 (step 10 or the maximum rate of the GS-13 range)--a starting difference of $11,277. In setting the grade limits of particular occupations, the Bank Board is restricted to the grade limits of particular occupations, the Bank Board is restricted to the criteria of classification standards published by OPM (in many cases 15 to 20 years ago) while the other agencies can determine the value of their occupations according to current industry conditions. Furthermore, in promoting individual employees, the Bank Board is

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restricted to narrowly defined increases rather than to levels commensurate with employees' contributions.

The Bank Board suffers further disadvantages with regard to compensation enhancements. The FDIC, for example, annually grants each of its employees a regional pay differential over and above any governmentwide cost of living adjustment. The differential varies from year to year and from one geographic region to another, but all FDIC employees in 1985 received between approximately 2 percent to 10 percent in addition to their base compensation. In 1986, when all federal employees (including Bank Board staff) are receiving no salary adjustment, FDIC employees are receiving an increase between 7 percent to 20 percent on top of their base pay.

Another disparity of this kind exists regarding bonuses. The FRB can grant a bonus to all of its officers each year for superior performance, and the OCC has a salary increment program in which its superior professional employees can receive an increment between 2 percent and 14 percent of their basic pay. In contrast, OPM regulations governing Senior Executive Service (SES) performance bonuses restrict cash awards to 30 percent to 35 percent of the Bank Board's career SES staff. Under a liberal OPM interpretation of these regulations in 1985, we were permitted to grant bonuses to only three of our career SES employees. Similarly, Bank Board mid-level managers and supervisors were restricted to performance awards of between 2 percent to 3 percent of basic pay given the limitations imposed by OPM regulations on employees subject to Merit Pay regulations.

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Among these three agencies, the highest cost for life insurance is 7 cents biweekly for $1,000 of basic coverage (FRB) whereas Bank Board employees pay 20 cent biweekly for $1,000 of basic coverage. The cost disparity in health coverage is even more striking. The highest cost for Blue Cross-Blue Shield maximum family coverage among these other agencies is $20.64 biweekly (FRB) where parallel coverage for government Blue Cross-Blue Shield is $66.13 biweekly.

In addition, both the FRB and the FDIC offer employer-subsidized savings instruments for their employees. The FRB has both a thrift plan and a 401K plan in which the FRB will match 60 cents for every dollar contributed by an employee into these plans (up to a total of 6 percent). The FDIC provides a 401K plan in which

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it matches dollar for dollar of employee contributions up to a total of 5 percent. The OCC has developed a thrift plan but is awaiting final approval from the Treasury Department. The Bank Board, like other federal agencies, has neither a thrift plan nor 401K plan available for its employees.

Attachment 1 summarizes the benefit comparisons between the Bank Board and these other agencies. We believe it is obvious that the playing field is far from level and that the Bank Board is at a severe disadvantage in trying to compete for the best talent in the marketplace. As long as the restrictions of the Classification Act, the Senior Executive Service, and Merit Pay continue to apply, these disadvantages will continue and intensify.

To illustrate the impact of these disparities on our recruitment and retention capability, we are providing you with specific case example in attachment 2. We hear these problems cited continuously by our managers and supervisors.

In light of the disparities we have described above and their impact on our ability to recruit and retain talented staff, we continue to be in dire need of relief from several civil service provisions. First, of course, is relief from the Classification Act itself. It is clear that OPM has the authority to interpret the coverage provisions of the Classification Act and to exempt agencies if they fall within the statutory list of exemptions. Attachment 3 represents the legal argument we have developed in support of an exemption. We believe that OPM should recognize our authority to fix the compensation of our employees.

Second, we need relief from the provisions of Merit Pay and the Senior Executive Service. To obtain an exemption from the Classification Act without comparable flexibility for our senior staff (SES or Merit Pay) would frustrate our basic effort to achieve equity.

Third, we also need the flexibility to offer benefit programs similar to those at the FRB, FDIC, and OCC. We believe the authority to establish such benefits would be implicit in an exemption for the Classification Act but, if not, we are seeking separate authorization to do so. Even if OPM maintained its position that the Bank Board is subject to the Classification Act, we would still need the authority to offer these benefit enhancements as a partial solution to our problems.

As a final request, if OPM does not decide to exempt our agency from the Classification Act, we seek approval to establish special pay rates for our occupational series most severely affected by the compensation disparities cited above. This relief, of course, is a last fallback position from the first

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three requests because it allows us only to relieve the problems in certain parts of the organization with respect to basic pay.

In my opinion, perpetuation of the disparities and relative inequities which exist today--and have given this agency unnecessary grief for too long a time--works to the detriment of a sound national thrift institutions system.

Sincerely,

s/ Edwin J. Gray

Edwin J. Gray
Chairman

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RECRUITMENT

- In recruitment events, the Bank Board has participated with the top 10 banking and investment firms including: Hanover's Trust, Mellon Bank, Bank of Chicago, Continental Illinois, Exxon, Morgan Guaranty Bank and Trust, and Citibank. These companies offer starting salaries in the range of $32,000 to $36,000. Candidates are incredulous when they learn that the Bank Board offers a starting salary of $21,804 (GS-9, step 1). An MBA candidate interviewed at the Wharton School of Business stated that he would accept employment with the Bank Board only if offered a starting salary of $42,000.

- Another candidate declined initial federal employment as a financial analyst with the Bank Board because we could not pay his relocation expenses while FDIC could.

- Secretarial candidates decline offers of employment citing, as a reason, higher paying private industry positions. As an example, one major policy office has five secretarial vacancies which we have not been able to fill: two have been vacant six months, one has been vacant five months, and two have been vacant two months.

- Candidates for secretarial positions from temporary companies continually decline Bank Board employment because they can make more money as temporary contract clerical help. As an example, a candidate was offered a clerical position at a salary of $12,862 per annum (GS-4, step 1), a rate of $6.16 per hour. She currently earns between $8.00 and $11.00 per hour and declined because she couldn't afford the loss in income.

- A secretary declined our offer of employment when her firm offered her a $3,000 increase to stay.

- A candidate declined the position of financial analyst because, on his salary, he would not be able to afford the cost of living in Washington, DC.

RETENTION

- Over the last two years, approximately 20 employees (including some of our most experienced managers in the financial and legal occupations) resigned from the Bank Board to accept employment with the Federal Home Loan

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Bank System because of higher salaries and better benefits.

- In the last month, a financial analyst resigned and accepted a lateral job offer with the Comptroller of the Currency. A major contributing factor in this decision was an opportunity to participate in their more lucrative bonus system.

- Over the past six months, eight administrative employees have resigned to accept employment with FDIC due to their salary flexibility and annual cost of living increases. Two employees, who recently accepted lateral transfers to FDIC, received an immediate increase in compensation of between $2,500 and $4,000 annually due to the FDIC regional pay differential program.

- An attorney just recently resigned from the Bank Board to accept employment with a private law firm at a salary double that earned as a federal employee. In fact, from June 1984 to June 1985, the Office of General Counsel lost 16 attorneys to private industry. Entry-level attorneys often cite improved opportunities for rapid promotions at law firms rather than the one-grade government requirement. Experienced attorneys usually join firms either starting or expanding thrift/banking practices. A GS-14 attorney can usually receive a 15 to 20 percent salary increase and join a firm as senior associate with prospects excellent for making partner within one to two years. Additionally, within the past two-and-one-half years, six attorneys have left the Office of General Counsel to join the Federal Home Loan Bank System.

- Two financial economists qualified at the GS-9 and GS-11 level under OPM standards resigned because they felt their qualifications warranted a two-grade higher rating.

- Turnover continued to be high during the last two fiscal years: an average of 23.6 percent for fiscal year 84 and fiscal year 85, compared to the governmentwide rates of 11.4 percent and 12.3 percent for fiscal year 83 and fiscal year 84, respectively (the latest available figures).

- 32 percent of employee separations in fiscal year 85 were at the GS-13 level and above compared with 24.9 percent in fiscal year 84 and 51 percent in fiscal year 83. In fiscal year 85, there was a phenomenal turnover of staff at the GS-13 level and above. For three of

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the major policy offices, that turnover rate was: Office of General Counsel, 52 percent; Office of Examinations and Supervision, 39 percent; Federal Savings and Loan Insurance Corporation, 33 percent.

- The reason for resignation as one employee stated in the following letter to his supervisor is representative of the problems the Bank Board is experiencing in retaining qualified employees.

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Legal Arguments in Support of an Exemption from the Classification Act for the FHLBB and the FSLIC

Inclusion within the statutory definitions:

The Classification Act (Chapter 51 of Title 5 U.S.C.) applies to "executive agencies" (5 U.S.C. S. 5102(a)(1)(A)), a term which is defined as including "government corporations" and "independent establishments" (5 U.S.C. S. 105).

The Federal Home Loan Bank Board (FHLBB) is "an independent agency in the executive branch" under S. 17 of the Federal Home Loan Bank Act (FHLB Act), 12 U.S.C. S. 1437. Under 5 U.S.C. S. 104, an "independent establishment" is defined as "an establishment in the executive branch . . . which is not an executive department, military department, government corporation, or part thereof, or part of an independent establishment." Thus, the FHLBB clearly is an independent establishment as defined in title 5.

The Federal Savings and Loan Corporation (FSLIC) is "a body corporate" and "an instrumentality of the United States" under S. 402(c) of title IV of the National Housing Act (NHA), 12 U.S.C. S. 1725(c), and is a "wholly owned government corporation" under 31 U.S.C. S. 9101(3) (Government Corporation Control Act as codified in title 31 of the U.S. Code). Under 5 U.S.C. S. 103, a "government corporation" is defined as "a corporation owned or controlled by the government of the United States." Thus, a wholly owned government corporation under title 31 is clearly a government corporation under title 5.

Exemption from coverage of the Classification Act:

If an agency is an "executive agency," the only way to escape application of the Classification Act is to fall within one of the exemptions listed in 5 U.S.C. S. 5102(b). Section 5103 of title 5 gives the Office of Personnel Management (OPM) the authority to determine the applicability of S. 5102 to specific positions and employees. Over the years, the FHLBB and the FSLIC have argued that they fell within exemption (25), among others.

Exemption (25) states that the Classification Act does not apply to "positions for which rates of basic pay are individually fixed, or expressly authorized to be fixed, by other statute, at or in excess of the maximum rate for GS-18."

Arguments in support of exemption (25):

The basic pay for the FHLBB's Chairman and Board Members is clearly "individually fixed" by 5 U.S.C. S.S. 5314 and 5315 at

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and in excess of the maximum rate for GS-18, since it is fixed at level III and level IV of the executive schedule, respectively.

Section 19 of the FHLB Act, 12 U.S.C. S. 1439, authorized the FHLBB to "select, employ, and fix the compensation" of such officers, employees, attorneys, and agents as shall be necessary for the performance of its duties without regard to the provisions of other laws applicable to the employment or compensation of officers, employees, attorneys, and agents of the United States." (Emphasis added.) However, "[n]o such officer, employee, attorney, or agents shall be paid compensation at a rate in excess of the rate provided in the case of members of the Board." In addition, language added in 1935 to S. 19 of the FHLB Act, states, as to the FHLBB's employees, that their "employment, compensation leave, and expenses shall be governed solely by the provision of this chapter, specific amendments thereof, and rules and regulations of the Board not inconsistent therewith."

Thus, S. 19 of the FHLB Act clearly is a statute which "expressly authorizes" the FHLBB to fix the compensation of its officers, employees, attorneys, and agents at or in excess of the maximum rate for GS-18, although the maximum rate authorized by S. 19 is that "provided in the case of members of the Board" (level IV of the executive schedule), a rate in excess of the maximum for GS-18. The fact that rates of basic pay are authorized to be fixed at or in excess of the maximum for GS-18 does not necessarily mean that any or all employees' basic pay must be set at that rate. It merely means that the agency has discretion to set basic pay rates at that level if it chooses.

Section 402(c)(5) of title IV of the National Housing Act (NHA), 12 U.S.C. S. 1725, contains language similar to that of S. 19 of the FHLB Act in that it authorizes the FHLBB to fix the compensation of the FSLIC's officers, employees, attorneys, and agents "without regard to the provisions of any other laws relating to the employment or compensation of officers or employees of the United States."

Some, including the codifiers of the U.S. Code, have taken the position that the "without regard" language of S. 19 of the FHLB Act and S. 402(c)(5) of title IV of the National Housing Act is obsolete and superceded because Public Law 880, the Act of November 26, 1940, Ch. 919, title I, S. 1, 54 Stat. 1211, and Executive Order 8743, April 23, 1941, covered most excepted positions into the competitive civil service and the Classification Act by its own terms (5 U.S.C. S. 5102(b)) applies, except as provided in 5 U.S.C. S.S. 5102(c) and (d), to "all civilian positions and employees in or under an agency." Therefore, they argue that the "without regard" provisions of S. 19 of the FHLB Act and S. 402(c)(5) of the NHA are clearly inconsistent with these later provisions.

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In addition, it is sometimes argued that the "without regard" provisions of S. 19 of the FHLB Act and S. 402(c)(5) of title IV of the NHA were made obsolete and superceded by the Classification Act of 1949 (1949 act), 63 Stat. 954, because a major purpose of the 1949 act was to include in its coverage positions and agencies which had been excepted from the Classification Act of 1923. Section 201 of the 1949 act (now codified as 5 U.S.C. S. 5102) clearly included the FHLBB and the FSLIC within the definition of "agency" to which the act applied; and S.S. 1202 and 1204 of the 1949 act, 63 Stat. 972, 973, repealed the Classification Act of 1923 and all laws or part of laws inconsistent with the 1949 act to the extent of such inconsistency.

Nevertheless, Congress has never explicitly repealed the "without regard" provisions of S. 19 of the FHLB Act and S. 402(c)(5) of title IV of the NHA. Unlike title 5 or title 31, Congress has not adopted the codified version of title 12. In the absence of express repeal, unless the provisions can be construed to have been repealed by implication, these provisions should govern.

Repeals by implication are not favored, so courts have generally required that the legislative intent to repeal must be clear and manifest. That is not the case here. In addition, neither of the two well-settled categories of repeals by implication apply since (1) the provisions of the two acts and those of title 5 and its predecessors are not in irreconcilable conflict and (2) the provisions of title 5 do not necessarily cover the whole subject and clearly act as a substitute for the provisions of the FHLB Act and the NHA. See Posadas v. National City Bank, 296 U.S. 497, at 503.

It should be noted that 5 U.S.C. S. 5102(c) contains 27 numbered exemptions, some of which are described in general terms, which Congress added to avoid conflict with existing laws governing the employment and compensation of various classes of federal employees. Several of these exemptions, including number (25) are consistent with the provisions of S. 19 of the FHLB Act and S. 402(c) of the title IV of the NHA. Thus, it is not at all clear that in enacting the 1949 act or in subsequently codifying title 5 in 1966 that Congress intended to implicitly repeal S. 19 of the FHLB Act and S. 402(c) of title IV of the NHA.

For the above reasons, the FHLBB and the FSLIC should be found to be within the provisions of exemption (25) in 5 U.S.C. S. 5102(c) and therefore be exempt from the Classification Act (Chapter 51 of title 5) and related provisions of title 5 of the United States Code.

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ADDENDUM B

STATEMENT

OF

THE FEDERAL HOME LOAN BANK BOARD

SUBMITTED* BY

WILLIAM K. BLACK, DEPUTY DIRECTOR, FSLIC

AND

WILLIAM L. ROBERTSON, DIRECTOR, ORPOS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS,

SUPERVISION, REGULATION AND INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HOUSE OF REPRESENTATIVES

ONE-HUNDREDTH CONGRESS

JUNE 9, 1987

Mr. Chairman, distinguished members of the subcommittee, we are pleased to respond to your request that the Federal Home Loan Bank Board (Bank Board or Board) testify concerning problems incurred by insured institutions as a result of bank fraud and insider abuse, and concerning Bank Secrecy and Change of Control Act reforms that were enacted, in substantial part, due to this subcommittee's efforts. With regard to thrift failures, you have asked us to address the causes of failures--particularly the correlation between fraud and insider abuse and thrift failures; the impact of such abuses; what the Bank Board has done to combat such failures; and how Congress can aid the Bank Board in preventing future abuses and thrift failures.

By way of overview, insider abuse and fraud are very significant contributors to thrift losses and failures. Risky investment strategies, usually including excessive growth and grossly inadequate underwriting practices are also major causes of thrift

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losses and failures. Worse, both of these primary contributors to the losses of the Federal Savings and Loan Insurance Corporation (FSLIC) are often present simultaneously in our most expensive thrift failures. Combined, these two causes of losses are overwhelmingly responsible for virtually all recent failures, FSLIC's growing insolvency, and the huge coming losses that we have already identified.

As we will explain at some length, FSLIC and the Bank Board have taken tremendous regulatory and personnel steps to combat fraud, insider abuse, and imprudent investment strategies. Congress can help by enacting proposed statutory language that the Bank Board has proposed to enhance the fight against insider abuse and fraud; by increasing the resources the Department of Justice brings to bear against criminal misconduct involving thrifts; and by deleting the so-called forbearance language in the House recapitalization bill--which would be used by those engaged in fraud and insider abuse to delay the Bank Board from ending their misconduct.

Too often, the cases involving FSLIC's largest losses have borne an uncanny resemblance to each other. The general pattern was a state-chartered association that underwent a change of control in 1982 or 1983, massive growth, adoption of a risky investment strategy emphasizing acquisition, development, and construction (ADC) loans, acquisition, development, and land (ADL) loans, and direct investments. Underwriting was often extremely poor. Insider abuse was usually present, and actual fraud was far from rare.

The change of control often brought a real estate developer into control of the thrift. For the unscrupulous developer, owning a thrift was a dream come true--a virtual printing press to provide money to develop his real estate. Typically, the new manager put minimal capital into the acquisition. Indeed, some changes of control were funded by overappraised real property, without any cash infusion.

The growth rate of many of these thrifts skyrocketed after the changes of control. Growth rates of 100 percent a year became common. Exhibits 1 and 2 are charts that show the difference in growth rates among 40 of the weaker Texas thrifts, the remainder of Texas thrifts, and the U.S. average. As you can see, the difference was phenomenal. In one year, the average growth of the "Texas 40" was nearly 100 percent. Prudent underwriting is almost impossible when a thrift grows extremely rapidly. The pressure is immense to get the huge cash inflow obtained from massive deposit growth invested quickly so that it can start earning a return.

The regulatory system that Chairman Gray inherited created a perverse incentive for massive growth. His predecessors reduced

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the capital requirement from 5 to 3 percent, allowed 5-year averaging and 20-year phase-in, and debased even the minimal capital requirement that remained by creating regulatory capital definitions that materially overstated thrifts' financial health. The result was that a thrift's percentage capital requirement declined if it grew more quickly. By growing fast enough, and taking advantage of five-year averaging, some thrifts had net worth requirements of 1 percent or less. Even that minimal net worth was often the product of bad accounting.

This massive growth went largely into highly risky investments, particularly ADC and ADL loans, and direct investments. Exhibit 3 demonstrates a much higher concentration of the Texas 40 and other Texas thrifts in these highly risky assets compared to the U.S. average. This pattern has been repeated by many state-chartered thrifts in states with liberal investment powers. The bad ADC and ADL loans that have caused FSLIC its most severe losses involved the thrift's making an investment that is structured as a loan, but bears an equity risk. The thrift would often fund 100 percent of the loan amount (i.e., no "downpayment" was required), plus all points and fees, plus the first two to three years' interest (retained as an interest reserve), and often an "equity kicker" that gave the thrift a percentage of the net profits of the project if it succeeded. Because these loans are extremely risky, they typically carried high interest rates, three to five points, and significant equity kickers. The loans generally required interest-only payments in the early years, and were sometimes made "without recourse" (i.e., without a personal guarantee by the borrower). Because the points and fees were booked immediately as income, the thrifts looked extremely profitable. Because of the high interest rate and the interest reserve, the thrift also looked profitable in the early years of the loan. The "interest reserve" was an important device. For example, for a two-year $1 million principal amount loan at 10 percent interest, the borrower would sign a note for $1.2 million, and the thrift would disburse $1 million to the borrower and create an interest reserve on its books of $200,000. Each month, the thrift would make a bookkeeping entry "paying" itself the interest the borrower owed that month. This entry allowed the thrift to book the interest as income. The interest reserve also meant that the loan could not become delinquent as long as the reserve was not exhausted. This meant that our prior system of identifying nonperforming loans--delinquency of 60 days or more--was useless for bad ADC and ADL loans.

The overall impact of bad ADC and ADL loans was that the thrift booked tremendous income from paying itself points and interest while making highly risky loans with a tremendous danger of default, covered up the risk of default through an interest reserve, and created strong incentives for the borrower to walk away from the project if any problems developed. When combined with poor underwriting, appraisal, and disbursement practices--or

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outright fraud--such loans were a prescription for disaster. An example of poor disbursement controls was Guaranty Savings of Arkansas, which was the lead lender on what was supposed to be a massive urban country club. Instead, Guaranty disbursed $22 million and ended up with (actually, FSLIC has ended up with) a five-story hole in the ground occupying virtually a city block in downtown Dallas, Texas.

Empire Savings of Mesquite, Texas, reported that it was one of the most profitable thrifts in the country--and then failed catastrophically. It combined direct investments, structured as ADC and ADL loans, with fraud to produce massive losses.

Even when the interest reserve ran out, thrifts were often able to disguise their ADC and ADL losses through several devices. First, the thrifts often refinanced their own loans just before the interest reserve would have run out. Second, groups of thrifts would develop "back scratching" arrangements whereby they would refinance or purchase each others' bad loans if the supervisory agent was preventing self-refinancing or the examiners were looking too closely at such practices. These refinancings allowed the thrifts to book additional income and avoid any loan defaults. They also caused the thrifts' risk exposure to grow even larger. Third, even if the earlier loans began to default after the interest reserves were exhausted, a thrift could continue to report high net profitability if it grew quickly enough and the new income outweighed the, by now, relatively much smaller, old nonperforming loans. This was a variant of the old pyramid scheme.

Examiners and supervisory agents had very limited means of preventing such abuses before 1985. Reappraisals ordered by the principal supervisory agent (PSA) of our ninth district, which includes Texas, took an average of nine months to complete. By the time the reappraisal was complete, the thrift often had already doubled in size. Once the reappraisal came in indicating a serious loss, the property could be refinanced or purchased by another thrift or a shill in a back scratching deal at a purported profit. The shills who purchased such properties generally received a nonrecourse loan for the full purchase price and interest. They had no risk, and were happy to "purchase" the property at an inflated price. The examiners were left to start all over again trying to prove the existence of losses. Virtually all of our enforcement powers are triggered by existence of such losses.

The typical problem ADC and ADL "loan" we have described is really a direct investment--it poses an equity risk to the thrift. The thrifts that have made the largest number of such ADC and ADL loans and direct investments have fared disastrously. Exhibit 4 shows the problem loan ratios of the Texas 40 as compared to the U.S. average and all other Texas thrifts. The

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differences are dramatic, and reflect the different investment strategies these three groups employed. (See exhibit 3.) Similarly, of the 37 thrifts that placed more than 10 percent of their assets in direct investments in 1983, 21 of these thrifts had been placed into receivership or conservatorship or are currently of significant supervisory concern.

These ADC and ADL problems were abetted by many professionals. Appraisers provided the inflated valuations and participated in, or blinked at, "land flips" designed to overstate the value of property through sham sales. Accountants failed to require that the ADC and ADL loans that were really direct investments be properly accounted for under generally accepted accounting principles (GAAP). The phony ADC and ADL income could not have been booked without such improper accounting. Attorneys provided the "creativity" necessary for sham transactions. "Shopping" for the professionals who were willing to "blink" at such improprieties, or even to plan them, became endemic among the worse managed thrifts. Similarly, borrowers learned to shop for the worst managed thrifts.

On its surface, these problem ADC and ADL loans are so insane that it seems irrational for any thrift manager to engage in such practices. From some thrift managers' perspectives, however, it could pay to make such loans. By booking high income the managers could justify awarding themselves high salaries, bonuses, and dividends. They also increased their reported net worth, which in turn allowed them to make still larger loans and book still larger profits. Some managers also gained from loans because they were giving money to themselves through conflicts of interest or through kickbacks from borrowers. Until our growth regulation brought the pyramid scheme to a halt, the massive growth of the worst managed thrifts allowed most of these thrifts to continue to report profitability. This was a sham. The worst managed thrifts were able to report as "profits" the act of essentially giving away their money and making themselves insolvent. These problem loans never made any sense. The decline of the regional economy merely exacerbated losses. For example, on average the Texas 40 were insolvent on a tangible capital basis by the end of 1984--well before the steep 1986 drop in oil prices.

The carnage that such risky investment and growth strategies and insider abuse and fraud have left is staggering. Virtually all FSLIC's recent and pending major losses are explained by such practices. They account for the fact that FSLIC was insolvent by $6.3 billion by the end of 1986 and is now down to well under $1 billion in cash and securities. That insolvency, in turn, is not simply "technical." It has had real and painful results for the FSLIC and the thrift industry. It has exhausted the secondary reserve and thereby reduced the thrift industry's net worth by $823 million. It may also lead the accounting profession to

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require thrifts to "write off" $4.8 billion in FSLIC notes held by thrifts.

FSLIC's insolvency also caused the outside accountants of the Federal Home Loan Bank of Dallas to question the value of FSLIC's guarantee of loans the Dallas Bank had made to problem thrifts. This led to the Dallas Bank "calling" our guarantee, and required FSLIC to send over $1 billion in cash to the Dallas Bank. It has also meant that very substantial FSLIC guarantees are unlikely to be made in the future until FSLIC is restored to financial health. FSLIC guaranteed loans used to be an effective means of "leveraging" our very limited cash. Without such guarantees, many problem thrifts must increase their deposit rates to maintain their liquidity. This, in turn, increases their net operating losses, which are already running at $3.8 billion annually (approximately $1.68 billion at Texas significant supervisory cases). It also causes healthy thrifts to have to bid up their deposit rates to compete for deposits. This increases their expenses and reduces their profitability or increases their losses. Nationwide, the difference in deposit rates between FSLIC-insured and FDIC-insured institutions is running at more than $4 billion a year. Well-managed Texas thrifts are the worst victims of these "high rate junkies." Exhibit 5 shows the precipitous decline in Texas mortgage spreads from the end of 1985 to 1986--at a time when the U.S. average was improving. FSLIC has now suffered seven consecutive months of net new deposit declines, with much of that loss suffered in Texas. Until FSLIC can resolve the problem of the high rate junkies, well-managed Texas thrifts will be forced to carry them like a heavy ball and chain. Absent the $15 billion recapitalization, FSLIC will not be able to resolve many hopelessly insolvent thrifts. Over $2.5 billion in net operating losses have occurred since the FSLIC recapitalization bill was first put on hold in October 1986.

Agency Initiatives to Address Problems

The Bank Board has been working to address these problems in numerous ways. We have testified before the Congress that budget and staffing constraints on FSLIC by the Office of Management and Budget (OMB) and by the Office of Personnel Management (OPM) have severely impaired our ability over time to attract, hire, and retain high quality agency staff in the numbers required. The past response by OMB and OPM to our critical needs in this regard has been grossly inadequate, to say the least.

In order to protect the safety and soundness of the thrift industry in the face of OMB's and OPM's unresponsiveness the Board has taken positive and aggressive action to strengthen its examination and supervisory efforts. As of July 6, 1985, the Board transferred its field examination function to the Federal Home Loan Banks (FHLBanks) in order to build a well-trained,

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effective, and efficient field examination force. By December 31, 1985, the number of professional examiners on the staffs of the FHLBanks grew from 747 to 1,003, an increase of 34.3 percent. The Board established a goal of at least 1,500 examiners for the FHLBanks by the end of 1986; there were 1,524 professional examiners as of December 31, 1986. Many of these new examiners have advanced degrees in business or finance and/or have professional designations, such as Certified Public Accountant.

These Board initiatives have resulted in a doubling of the professional field examination staff in just a year and a half, and a tripling of the professional supervisory staff since 1984. The professional supervisory staffing levels were increased by 62.2 percent to 550 nationwide during calendar year 1986. Training of both examination and supervisory personnel was conducted at an all-time high level during 1986.

The Board determined that its purpose of improving the effectiveness of its examination and supervisory functions would be best served by establishing within the FHLBank System a new Office of Regulatory Policy, Oversight, and Supervision (ORPOS) through which to exercise its statutory responsibility to oversee, control, and, where necessary, improve those functions. On July 24, 1986, the Board voted to establish ORPOS, and this was done effective September 27, 1986.

Another significant response undertaken by the Board to deal with the real causes of FSLIC losses was the expansion of our enforcement program. In late 1985, the Office of Enforcement (OE) was created by the transfer of personnel and responsibilities from within the Office of General Counsel to an independent office. OE was created to increase the number of enforcement personnel to keep pace with the increase in supervisory staff at the FHLBanks, to expand the independence and effectiveness of enforcement personnel, and to enable the staff to address better and more quickly the referrals for formal enforcement action against violations of laws and regulations and unsafe and unsound practices in the thrift industry.

During calendar year 1986, OE obtained 58 cease-and-desist orders and 48 removal-and-prohibition orders, and completed 15 securities cases. This represents a substantial increase over the number of actions during 1985, thereby aiding preservation of the FSLIC insurance fund.

Additionally, both OE and the Office of General Counsel have been working with the U.S. Department of Justice. Since part of the cause of FSLIC losses has involved suspected criminal conduct such as insider abuse and fraud, the Board had more than quadrupled its number of criminal referrals in 1986 over 1985, and is currently proceeding at a pace that could well exceed that number in 1987.

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In addition, to underscore the full commitment to the Board's enforcement efforts, the Chairman has issued a series of supervisory directives, beginning April 12, 1984, and culminating as recently as May 22, 1987, to ensure that, despite any staffing or other constraints, the FHLBanks and the Board's staff respond decisively to all material violations, and to highlight particular areas of concern.

Another tool related to an effective enforcement program is civil litigation in the federal courts. Over the last four years the Board has nearly quadrupled the size of its litigation staff, thereby substantially increasing suits against officers, directors, and professionals who have caused losses to the FSLIC. As a result, damage recoveries for FSLIC are on a steady increase. In recent years, we have begun to concentrate our litigation efforts at obtaining injunctive relief as soon as it is legally possible, in order to maximize deterrence and minimize the dissipation of assets by insiders who have looted insured institutions. FSLIC has met with considerable success in the courts in obtaining "freeze" orders--effectively preventing continued abuse of the institution or its assets by directors or officers named in our complaints.

THE BOARD'S REGULATORY RESPONSE

During the last several years, the Board has undertaken a comprehensive regulatory program designed to promote capital adequacy in the thrift industry; limit risky investments, especially by undercapitalized or insolvent institutions; prescribe more realistic recordkeeping and reporting in the industry; and encourage allocation of adequate allowances for loan losses when assets have been identified as posing problems of collectibility. Each of these regulations should be viewed as part of the larger program, and that the larger program is guided by two key principles. First, we must recognize that FSLIC is an insurance company and its safety and soundness are imperative. Second, such regulations should generally give greater latitude to well-capitalized, well-managed thrifts.

The Board's regulatory initiatives have been comprehensive. We have attached a description of these initiatives as exhibit 6.

BARRIERS TO PRUDENT REGULATION

The regulatory achievements of the Board during the past four years have, all too often, come in spite of tremendous industry opposition, and often the opposition of key state regulators. For example, in a letter received by the Board dated July 12, 1984, the Texas Savings and Loan League opposed the direct investment regulation, noting that the Dallas and San Francisco districts had booked record profits in 1982 and 1983, arguing

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that "risk management techniques have evolved so as to reduce the potential exposure of associations engaged in these activities." A year later, the Texas League opposed the proposed regulation on classification of assets, and on June 30, 1986, the Texas League assailed the Board's "sweeping round" of regulatory changes (net worth, liquidity, and nationwide lending) for discouraging the entry of new capital into the thrift industry:

> The commerce of this country must be financed. We cannot have riskless financing and economic growth.... [W]ith good industry managers, with cooperation, patience and understandings [sic] from the regulators and with the advantages and natural functions of an open market place, the savings and loan industry will continue to be a viable component in the financial institution industry.

A now troubled thrift opposed the direct investment regulation in its December 27, 1984, letter with the comment that "...unless we are allowed to compete and grow as fast as sound business judgment requires and supports, we cannot long survive." (Emphasis in the original.) By January 24, 1986, its letter regarding the classification of assets regulation reflected the improvements in the Board's examination and supervision process:

> Indeed, this regulation could result in the death of the Savings and Loan industry. During a period in which the industry and regulatory sectors need to come closer together, this regulation causes the industry to become more defensive and antagonized by the examiners.

The permissive investment powers of some states for state-chartered, but federally insured, thrifts has also helped create incentives for certain thrifts to utilize these powers for high risk investments, under the philosophy "heads I win, tails the FSLIC loses." The December 26, 1984, comment letter from Texas Savings and Loan Commissioner L.L. Bowman, III, regulator of a state with some of the most liberal direct investment authority in the nation, opposed the Board's proposals on direct investments, net worth, and ADC loans:

> My primary concern over the proposed definition of acquisition, development, and construction loans stems primarily from the hazard of allowing an examiner to interpret complicated accounting principles and arrive at an arbitrary conclusion. I have long espoused the philosophy that this responsibility rests solely with the private audit firm which performs the association's annual audit....The new proposed net worth regulation (anti-growth) is by far the most damaging of the three regulatory proposals. Our industry is replete with associations whose background has been steeped in the

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> traditional purposes of thrifts and homeownership. Their portfolios bulge with long-term fixed-rate mortgages. The majority of these mortgages are well below current yields and represent the sword of Damocles to the boards of directors of these associations. Because of this asset mix, these associations are moving irrevocably toward failure, unless they can institute a program of rapid growth in rate-sensitive transactions....The growth necessary to offset such substandard portfolios would, of necessity, be far in excess of the limitations placed on the industry in this regulation.

NEEDED CONGRESSIONAL SUPPORT

Legislative action is essential to aid the Bank Board in its efforts to stop fraud and insider abuse. The most important legislative need is to eliminate the so-called forbearance provisions of the House recapitalization bill. As we have explained, the critical need for the thrift industry is higher capital, honest accounting, quicker regulatory response, and higher levels of compliance with law and regulations. Unfortunately, Congress has been unable to pass any expansion of our enforcement powers in the past four years. Worse, the House and Senate recapitalization bills contain not a single provision designed to aid the Bank Board in stopping fraud, insider abuse, and risky investments. Instead, the House bill, in particular, contains a panoply of provisions that will constrain the Bank Board's efforts to stop such losses.

We have already explained how our enforcement powers are generally tied to the existence of losses. The House and Senate bills would drastically curtail our ability to require thrifts to recognize the existence of losses by limiting our reappraisal and classification of asset powers to require thrifts to recognize the full extent of their losses. By purporting to limit losses to "GAAP" losses, these bills would further encourage accounting shopping.

The House bill bars FSLIC from requiring a thrift to increase its general loss reserves regardless of the amount of its assets classified "substandard"--which indicates an unusual danger of loss. That provision is indefensible.

The House bill creates an elaborate appeal and arbitration mechanism that can be used whenever a supervisory agent requires a thrift to recognize a loss. This is a perfect device for those engaged in insider abuse and fraud to delay any enforcement action that would stop such abuses. Those abusing a thrift have the strongest incentive to use the arbitration mechanism. The fact that the thrift has to pay the arbiters' costs is plainly irrelevant to such insiders.

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If the House truly believed that these provisions were desirable, it would have applied them to our sister banking regulatory agencies--who also use market value appraisals and asset classifications, require additional general loss reserves for substandard assets, and have no arbitration/appeal mechanism. Our sister regulatory agencies unanimously oppose such "forbearance" provisions as destructive of safety and soundness.

These provisions cannot be justified on the basis of alleged regulatory abuses by the Bank Board. This subcommittee held hearings on these allegations and received testimony on no such abuse of any thrift in Texas or elsewhere. The testimony included rhetoric and an anonymous "whisper" campaign attacking the Bank Board, but not a single example of an abused institution. This whisper campaign sank to its lowest level when it was alleged that the absence of a demonstration of abuse constituted proof that all thrifts were too intimidated to complain. By definition, it is logically impossible to refute such an allegation.

There is such a thing as rational forbearance, and the Bank Board's practice and policy statement provide for it. We temporarily forbear on our capital requirements for well-managed thrifts that have a real possibility of recover, have a sound plan for returning to adequate capital, and have made enforceable commitments to follow the plan.

Other thrifts, however, are hopelessly insolvent and losing more money every day they are unresolved. Such thrifts have a tremendous incentive to engage in risky or fraudulent behavior because they are in a "heads I win, tails FSLIC loses" situation. The vital legislative initiative needed to stop this incentive is a $15 billion FSLIC recapitalization plan that would allow us to resolve these cases.

For several years, the Bank Board has sought amendment of the Home Owners' Loan Act and of Title IV of the National Housing Act to clarify and strengthen its civil enforcement powers, as explained in Chairman Gray's testimony to this subcommittee on May 8, 1986. Some of the Bank Board's proposals have been introduced by the full committee (see, e.g., H.R. 4998, 99th Cong., 2d Sess., and H.R. 1680, 99th Cong., 1st Sess.); however, the Congress has not acted on these vital proposals.

Having failed on its own to elicit sufficient support for the amendment, the Board is now working with the other federal financial institutions' regulatory agencies to develop a joint legislative package for the enhancement of the civil enforcement authorities of all the agencies.

We would, however, like to take this opportunity to reiterate a few of those key enforcement areas in need of legislative

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revision. First is an amendment to permit the Board to issue a temporary cease-and-desist order on the grounds of disarray or lack of books and records. Deficient or nonexistent recordkeeping has been a recurrent problem in many of the serious difficulties encountered in resolving supervisory cases. When it is clear that an institution is in severe financial straits, the Bank Board must be able to halt new business activities to prevent further losses and insolvency. However, we are hampered in doing so under our current authority if our examiners cannot determine the financial condition of the institution when its books and records are woefully inadequate. This amendment would extricate the Board from its dilemma by permitting the Board to halt certain business activities of an institution immediately when its financial condition cannot be determined because of a disarray or lack of records. This would be an invaluable tool for preventing serious problems hidden by inadequate or nonexistent records from expanding into disasters during the time needed to reconstruct and identify the problems. Similarly, the Board should be expressly authorized to require the immediate termination of any violation of law or rule through issuance of a temporary cease-and-desist order.

Secondly, legislative amendment is needed to clarify that the Board's and the other federal financial institutions' regulatory agencies' authority to halt violations of law or regulation includes the right to require affirmative corrective action in the form of restitution, rescission, guarantees against loss, etc., by the institution or its management officials.

A further necessary clarification to the Board's enforcement authority concerns its removal and prohibition powers. For example, the grounds for removal of an officer from an institution for misconduct at another institution should be consistent with the grounds for a direct removal from the first institution. Moreover, the pertinent statutes should be amended to clarify that the agencies' removal authority is not affected by a director's or officer's resignation or other separation from the institution. The Board also has requested congressional expansion of the industrywide ban that presently exists for individuals who have been removed to cover not only FSLIC-insured thrifts, but all federally insured financial institutions. Currently, a thrift official removed from one FSLIC-insured institution may not serve as a director, officer, or employee at another FSLIC-insured institution; however, he or she may work for an FDIC-insured bank or an NCUA-insured credit union without penalty. The Board's suggested amendment would not only prohibit a removed individual from working at another FSLIC-insured institution, but also prohibit an individual removed by an agency from employment at any type of federally insured financial institution from serving at any other without prior approval of the appropriate regulatory agency.

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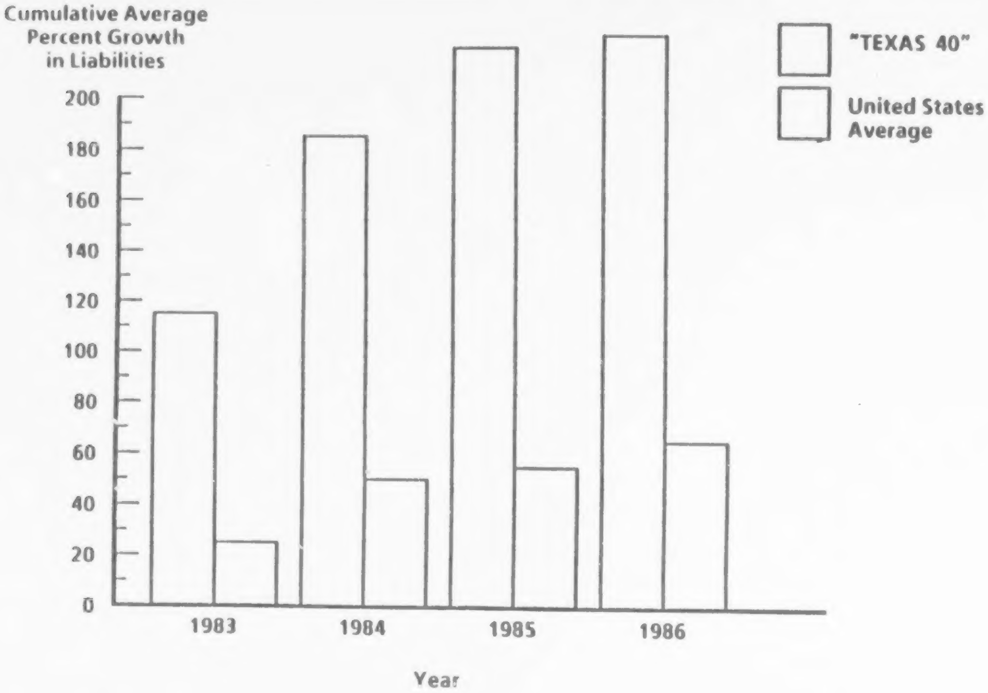
The new interagency draft of enforcement legislation also will include a desired expansion of the agencies' civil money penalty authority and increase certain of the existing penalty provisions in current law.

Moreover, the Bank Board is likely to seek in future legislative proposals the authority presently held by the federal banking agencies to mandate capital adequacy requirements for thrift institutions in the same manner as the banking regulators have for commercial banks. See 12 U.S.C. Section 3907. Among other things, the authority would assist in the prevention of insiders from dissipating the assets of an institution before corrective action could be initiated.

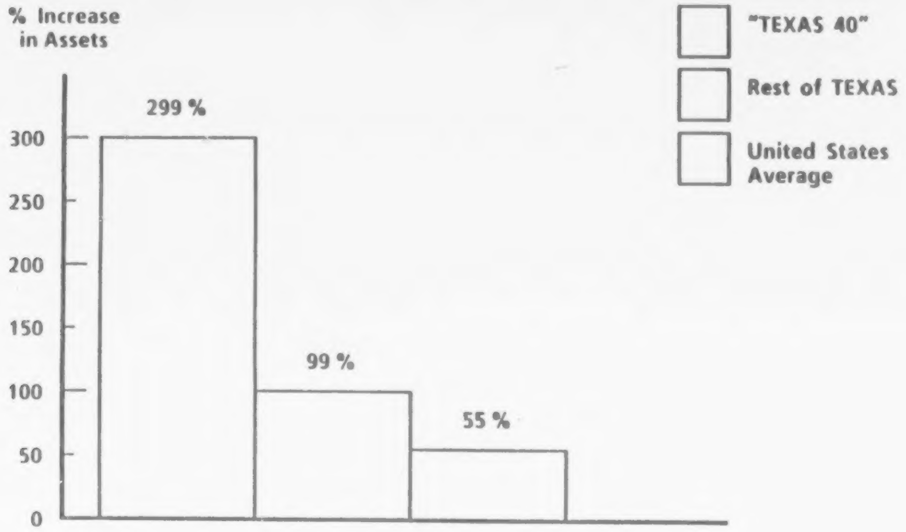
The grounds for appointing a receiver or conservator for a state-chartered thrift should be expanded to be identical with federally chartered thrifts. Currently, a conservator or receiver can be appointed for a federally chartered thrift that willfully violates a cease-and-desist order, but not a state-chartered association.

It would be scandalous to reduce the effectiveness of the Bank Board's tools against fraud, insider abuse, and imprudent investments. We cannot state too strongly our conclusion that the House recapitalization bill, because of its forbearance provisions, would increase FSLIC's losses and provide a shield for renewed insider abuse and fraud. We need your help to avoid this result.

Cumulative Average Annual Growth of the TEXAS 40 and the United States Average, 1983 - 1986



Extraordinary Growth of Texas Thrifts Between December 1982 and December 1986



Direct Investment, (D.I.) &
Acquisition, Development and
Land Loans (ADL)

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THE BOARD'S REGULATORY RESPONSE

Capital Regulation; Liability Growth Regulation

The net worth and liability growth regulations were developed by the Board in consultation with its field staff, and were formally adopted by the Board in January 1985. They curtail overleveraged deposit growth and require institutions to increase their capital as they increase their deposits. On August 15, 1986, the Board--again in close consultation with senior supervisory agents in the field--amended its net worth and growth regulations by building upon their basic frameworks.

The minimum capital requirements for thrift institutions adopted on August 15, 1986, and effective January 1, 1987, can be divided into three components: a liability component, a contingency component, and a maturity-matching credit. The liability component requires institutions to hold capital equal to 6 percent of their liabilities in excess of the level on their books on January 1, 1987. The capital requirement for the liability level on their books on January 1, 1987, will initially equal approximately 3 percent and will increase each year (until it reaches 6 percent) by a fraction of the average profitability in the industry during the preceding year. An institution's specific initial requirement will depend on its base requirement under the regulation in effect prior to January 1, 1987.

The contingency component requires institutions to hold incremental capital against certain assets. The contingency component includes a 2 percent requirement on recourse liabilities, a 2 percent requirement on standby letters of credit, and a 20 percent requirement on scheduled items. It also contains a variable component for which the incremental capital requirement depends on an institution's actual capital level and its concentration in a specific asset category. These variable incremental requirements apply to direct investments, under the Board's proposed Equity Risk Investment rule, direct investments, including land loans and nonresidential construction loans.

The maturity-matching credit allows institutions to reduce their capital requirement by up to 2 percent of liabilities for one-year and three-year cumulative hedged maturity gaps of less than 15 percent. Those with gaps of less than 25 percent receive credit on a declining scale, and gaps above 25 percent receive no credit. Institutions cannot use this credit to bring their overall requirement below 3 percent for the first three years of the regulation and not below 4 percent thereafter.

On January 31, 1985, the Board adopted, in conjunction with its final rule pertaining to net worth requirements for insured

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institutions, a new regulation, section 563.13-1, to prohibit any insured institution having assets in excess of $100,000,000 from increasing its total liabilities during any two consecutive quarters at an annual rate in excess of 25 percent unless a growth plan had been approved in advance by the institution's PSA. In order to obtain such approval, an institution was required to submit to its PSA a detailed growth plan containing information necessary for the PSA to determine the institution's ability to manage the resulting increase in size, whether the investments contemplated by such growth would be appropriately diversified, the stability of the funding sources and the risk of potential runs, and the interest rate and credit risk posed by the planned uses of funds.

The most recent amendment to this growth regulation, adopted at the same time as the capital regulation in August of 1986, clarified that institutions may not increase their total liabilities within any two-quarter period at a rate greater than 12.50 percent (still an annualized rate of 25 percent) without prior PSA approval. This growth limitation applies to every insured institution unless it is exempt because it meets or exceeds its current regulatory capital requirement.

Definition of Regulatory Capital Regulation; Proposed Policy Statement on Accounting for Acquisition, Development, and Construction (ADC) Loans

The Board is moving steadily in the direction of requiring insured institutions to report in compliance with generally accepted accounting principles (GAAP). In May of 1987, the Board issued a final rule on the Definition of Regulatory Capital. That rule requires that for periods beginning on or after January 1, 1988, insured institutions prepare in accordance with GAAP all financial statements, all audited financial statements and reports, all financial reports required to be filed with the Board, and all counterstatements. In addition, these statements and reports must include a footnote reconciliation of GAAP equity capital to regulatory capital.

The definition of regulatory capital includes equity capital, computed under GAAP, and items based on risk analysis reporting (RAR) that are not part of GAAP equity capital. Mutual insured institutions can only obtain external capital through the sale of subordinated debt, which would not qualify as GAAP capital, but is generally treated as capital for RAR purposes.

In keeping with this policy of applying GAAP accounting standards to insured institutions to the extent it is reasonable and possible to do so, the Board has proposed to amend its statements of policy relating to accounting for acquisition, development, and construction loans to comport with the position taken by the American Institute of Certified Public Accqountants and by the

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Chief Accountant of the Securities and Exchange Commission on determining whether a transaction characterized as an ADC loan is truly a loan or is, in substance, a real estate investment or participation in a joint venture.

Direct Investment Regulation

The new direct-investment rule significantly revised the investment thresholds beyond which institutions must obtain prior supervisory approval for their direct-investment activities. Institutions that fail their minimum capital requirement must still receive prior approval for all direct investments. Institutions that meet their minimum capital requirement but have less than 6 percent tangible capital may hold the greater of 3 percent of assets or two and one-half times their tangible capital in direct investments without supervisory review or approval. Beyond this threshold, supervisory review and approval is required. Finally, institutions meeting their minimum capital requirement and having at least 6 percent tangible capital may hold up to three times their tangible capital in direct investments before supervisory review and approval is required.

The new rule significantly strengthens the former rule by linking review thresholds to an institution's tangible capital, rather than regulatory capital, which includes such intangible assets as goodwill and deferred loan losses.

As was true with the previous regulation, the new rule retains the waiver provisions. That is, institutions that wish to engage in direct investments beyond their established thresholds may apply for a waiver from the PSA in their respective districts if the institution has the proper controls to limit its risk exposure.

The Board also issued a proposal that would define an "equity-risk investment" to include all direct investments as currently defined by the direct-investment regulation, as well as land loans and nonresidential construction loans with loan-to-value ratios greater than 80 percent or loan-to-cost ratios greater than 100 percent. These loans also would be subject to incremental capital requirements of up to 10 percent as established by the regulatory capital rule.

Proposed Rules on Classification of Assets and Appraisal Standards

In May 1987, the Board issued a proposal to amend its classification of assets regulation to ensure the use of broader, but judicious, examiner discretion in the classification of assets, consistent with the examination practices of the bank regulatory agencies. Heretofore, the Board's appraisal standards were published as supervisory memorandum R41c issued by its

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Office of Regulatory Policy, Oversight, and Supervision. The standards contained in R41c were substantially the same as those contained in its predecessor memorandum, R41b, praised as "highly developed and comprehensive" by the House Committee on Government Operations. The Board's current proposed regulation clarifies and simplifies its existing appraisal standards. The standards themselves, however, would continue to require derivation of a market value for properties in accordance with methodology accepted and in use by the appraisal industry.

The CHAIRMAN. Well, thank you very much, Chairman Gray.

You gentlemen were chairmen during a period 1979 to 1987. To make it clear, Chairman Janis served 1979 and 1980.

Mr. JANIS. Yes, sir.

The CHAIRMAN. Chairman Pratt, 1981–82; and Chairman Gray, 1983 through 1987.

Chairman Janis, as I indicated in my opening statement, I'm concerned that some States have acted irresponsibly in giving their State-chartered savings and loans permission to do almost anything with federally insured money. Some of our witnesses yesterday expressed similar concerns.

Why should the Federal Government insure the deposits of State-chartered institutions whose investment powers exceed those that Congress has determined to be appropriate and prudent for federally chartered institutions?

Mr. JANIS. I don't think it should, Mr. Chairman. I don't think we should. I think we should have a moratorium on State powers that should be put into effect right now.

The CHAIRMAN. How can we put that into effect? I agree with that. I'm somewhat frustrated. People say you can't get it done and I think whoever is chairman of the committee next year is going to be told the same thing, let's postpone it.

What's the quickest, most decisive way we could get that done, in your view? Can the regulators do it?

Mr. JANIS. Yes, sir. Two steps. First of all, I believe that you should do a resolution.

The CHAIRMAN. A sense of the Senate resolution?

SENATE RESOLUTION

Mr. JANIS. Yes, sir. And I have 12 things that I would put in that resolution for the short-term steps. That's the first one on my list.

Now after you do a resolution——

The CHAIRMAN. Will you quickly tell us what the other eleven are?

Mr. JANIS. Yes, sir. The second is growth. I would begin by telling the regulators to enforce existing regulations, that GAAP insolvency means no growth, and to focus on the kind of growth.

The CHAIRMAN. Say that again—GAAP insolvent, no growth——

Mr. JANIS. Well, I think those that are GAAP insolvent should not grow.

The CHAIRMAN. Very good. Those are the two recommendations that I've already made.

Mr. JANIS. Now there are some points that Senator Riegle had in his statement yesterday that I do agree with. In the interest rate risk area, I would suggest as a starting point better data and monitoring. The data right now is terrible on interest rate risk management and I consider the regulators having——

The CHAIRMAN. Can you give us what you regard as a practical—can all these things be in the resolution?

Mr. JANIS. Yes. Every one of these would be in the resolution. Fourth, weak companies should not be allowed to acquire insolvent companies. Fifth, in-kind capital should not be allowed as a substitute for cash equity investments in acquisitions and mergers. Sixth, get a better handle on the depth and size of the problem. This is that audit group idea that Senator Riegle referred to yesterday. Seventh, stop FSLIC from issuing notes to the Federal Home Loan Bank System. This is only going to drain the capital of the bank system at exactly the wrong time. Eighth, use your influence to get the taxing committees to help out on these FSLIC-assisted deals because all of that legislation is expiring this year—the NOL's and the FSLIC assistance. Ninth, restrict Federal powers. There are certain Federal powers that are excessive that could be restricted right now. Loan-to-value ratio lending should not be at 100 percent. Loans-to-one-borrower should not be at 100 percent capital. That's too high. Forty percent commercial real estate power is not necessary. Junk bonds should be put in the 10 percent commercial basket. Tenth, mortgage derivative securities ought to be restricted only for use for hedging purposes. It's a dangerous instrument if used otherwise. Eleventh, the Bank Board should focus on the easy solutions. They could close 300 institutions that are GAAP insolvent today for a little more than $2 billion and get rid of the risk of all those institutions staying open and doing risky things, i.e. throwing the "Hail Mary" pass.

The CHAIRMAN. Say close them right now at once?

Mr. JANIS. They're working on the tough ones. They're working on the big ones and they could use $2 billion—there are over 300 institutions that are just $2 billion GAAP insolvent in the aggregate. So just for $2 billion, they could take care of those 300 institutions and get them out of that risk category. Twelfth, give the commission a clear agenda for restructuring.

If I throw in a baker's dozen, I would say build a fire under FSLIC to make deals quicker. And if I add one more for good measure, I'd say delegate more supervisory power and responsibility to the field because supervision and examinations have had dramatic improvement in the last year or so.

That's what I would recommend as a resolution.

Now you asked the second part of the question, which is——

The CHAIRMAN. Let me move on because I want to get the reaction of the other members of the panel if I can quickly to this. Chairman Pratt, do you buy that baker's dozen or 14 point program?

Mr. PRATT. No. Those are Mr. Janis' recommendations. I would agree with a number of them. In responding to your original question, I think that the Federal Government if it's going to pick up the tab should control the risk and that over time the States should be brought into conformity with that. I think that's not a simple process because you have very large State-chartered California institutions which would need to make operating adjustments. But I firmly agree with that original premise. I also agree with some of Mr. Janis' suggestions.

The CHAIRMAN. You agree that we should have a sense of the Senate resolution and it should incorporate a substantial number of the proposals. How about the first two proposals that he recommended?

Mr. PRATT. I think that it is inappropriate for insolvent institutions to grow. I think it destroys the spread, the ability of others to earn income, for no good purpose. We're trying to save helpless cases frequently and we're doing it to the detriment of the rest of the industry. I think that that would be appropriate.

The CHAIRMAN. How about State-chartered institutions able to engage in activities not permitted by the Federal Government?

Mr. PRATT. Well, I think you need to do this over time. I believe they should have exactly the same regulation if they're going to pay the same insurance cost and the same permissiveness. You would need to go through a fairly lengthy process because you have large healthy institutions that diverge very substantially. Some of the most profitable, best capitalized, biggest institutions—there are some that diverge far afield from the Federal model.

The CHAIRMAN. OK. Mr. Gray.

Mr. GRAY. Well, I recommended in my testimony that the rules under which State and federally chartered thrifts insured by FSLIC operate be made uniform. I realize that that can't happen overnight. But I think it should happen as quickly as possible.

One thing that could be done is to immediately halt State-chartered authority to approve any new activities. We proposed this to the Congress in 1984 and 1985 and proposed to the industry that to the extent any activity exceeded that provided for under Garn-St Germain that institutions would have to pay a supplemental premium based on the risk of loss, with this mitigated somewhat by the amount of capital that an institution had.

Essentially, the spirit of what Jay has mentioned is something I agree with. I'd like to look again at all 12 of the things he's talking about.

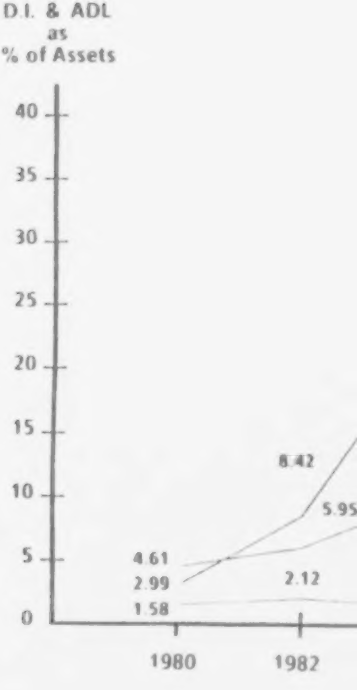
The CHAIRMAN. Thank you very much. My time is up. Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

I think one thing that has been made adequately clear over the last few weeks is that where we've probably made our biggest mistake—when I say we, I mean Congress—is in this issue of the State-chartered institutions. I plead guilty to being a States rights person on most issues: don't interfere with State government. But I think in the issue of insurance, it's certainly clear in hindsight that we should have done years ago what Chairman Proxmire is supporting and said, "Fine, you can go beyond Federal law, but if you want Federal insurance you cannot." I think that's the clearest thing that I've seen come out of this—where Congress is at fault, and I'm part of that fault of not overriding my States rights feeling and saying it just isn't fair for a Federal institution that is much more tightly controlled to pay the same rate and have the same guarantees as a State-chartered institution that's in mushroom farms or windmill farms or things of that nature.

I would think, Mr. Chairman, so that we don't create problems, we ought to try and move ahead with the caution that some are doing well under those regulations; but some method or timetable of implementing such a rule would be one of the most positive things that we could do for the future.

Mr. Janis, let me ask you a question. Going back to when you were Chairman in 1979 and 1980, I remember sitting in this room with Chairman Proxmire and concluding a conference with the House which started the phase-out of regulation Q. All of you remember that regulation Q was a temporary rule that lasted for 17


D.I. & ADL
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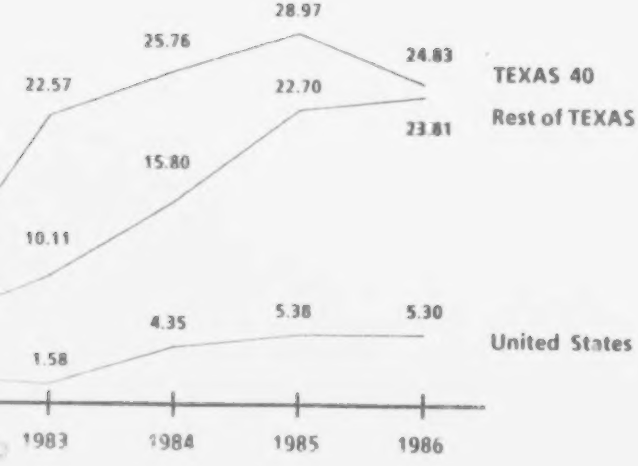
1980
1982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Rest of TEXAS
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United States
1983
1984
1985
1986

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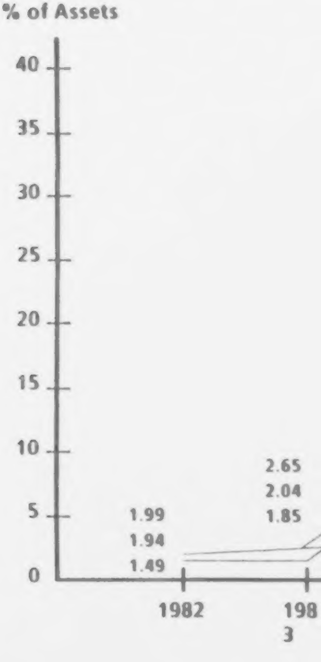
Problem


% of Assets
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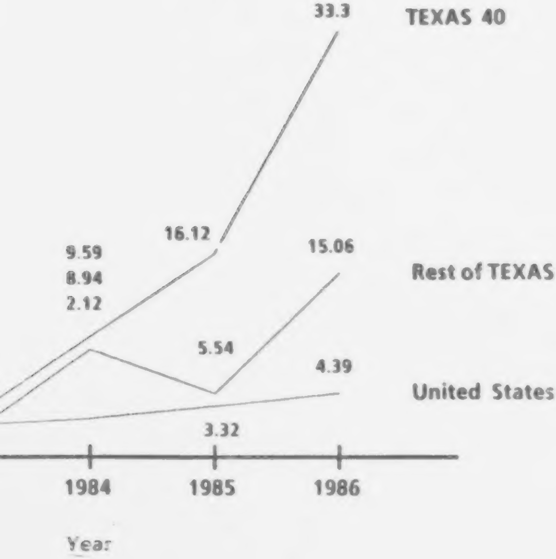
1982
198
3

Loans as a Percentage
# of Assets



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	84-Q4	85-Q1
Arkansas	221	175
Louisiana	88	152
Mississippi	194	223
New Mexico	145	218
Texas	149	206
District 9	147	197
United States	161	218

Source: Federal Home Loan Bank

Year

MORTGAGE YIELD SPREADS
(BASIS POINTS)

85-Q2	85-Q3	85-Q4	86-Q1	86-Q2	86-Q3	86-Q4
212	221	224	250	166	92	182
185	196	209	194	210	198	178
230	266	285	257	262	286	329
222	247	302	259	277	232	211
242	241	277	234	183	121	110
231	235	265	231	191	139	136
245	264	275	279	280	276	288

Dallas

years and it certainly gave S&L's a great deal of comfort. You didn't have to be too smart to run an S&L. The Government told you what you could pay and what you could charge and all of that, so you just followed the rules and you made a profit—until we got into the 21 percent prime.

Looking at that in hindsight, I still don't see any alternative to removing regulation Q because the S&L's were then coming up with all kinds of wild schemes—sweep accounts, the advertising on billboards—any way to attract money because tens of billions were flowing out to the Merrill Lynches of this world—excuse me, Mr. Pratt—to money market accounts—and it was a hemorrhage.

REGULATION Q

So I can see the problems that that has caused. But on the other hand, I'm wondering what you think the condition of the thrift industry would have been if, instead of removing reg Q, we had tied it to 5.25 and 5.5 percent interest rates.

Mr. JANIS. I think there are two or three parts to that answer, Senator. In the first place, I had toyed with the idea during my HUD days, which were just prior to the Bank Board, and I had proposed the regulation of the money market mutual funds to put them on the same level playing field as the savings and loans and the banks relative to reg Q. That might have worked. It probably wouldn't however, because of the forces that Dick Pratt talked about—competitive forces.

Senator GARN. I would interject that the Utah legislature tried to do that. There was an unbelievable fight and I'll guarantee you the securities people won. They tromped all over the bankers in that situation. It wasn't even a close fight as far as saying, "OK we're going to create a level playing field by putting interest rate ceilings and other regulations on money market funds."

Mr. JANIS. I think you're right. I think my idea probably wouldn't have worked in the long run, but it would have been something to have considered, but we had the Grey Panther and small saver lobbying, as you'll recall, in 1979 and 1980 for rapid deposit deregulation and I think we all yielded to that lobbying and I wish we hadn't.

But at any rate, we did. And I think the condition of the industry required that deregulation take place. I think the fault, however, was that none of us—and I'm to blame as well as anyone else in this room or anyone else in this country—sat down and figured out what the effects of deregulation were going to be, what would it mean. What it would mean in terms of new powers, examiners and things of that nature, and restructuring deposit insurance. That was the key thing that we didn't do. If you were the head of a private insurance company, you certainly would have restructured your insurance company had there been something as cataclysmic as deregulation, and we didn't do it—any of us. And I think we're at fault.

Senator GARN. Just to follow up because my time is up, but if we had not removed regulation Q, what condition do you think the industry would have been in a couple of years later?

Mr. JANIS. If we couldn't regulate the money market mutual funds, and I don't think we could have—I think you're probably right on that—then the only thing to do was to take away reg Q because if we hadn't, the industry would have been in a terrible liquidity crisis.

Senator GARN. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

I want to thank the witnesses for their testimony today.

I think this inquiry as we got into it yesterday and today is a very solemn affair. We're trying to piece together very complicated history and I think, Mr. Janis, as you say, an awful lot of things did come together at once. There may have been policy misjudgments, but a lot of outside circumstances combined to put us where we are today, and I think there were people—Mr. Gray, you and others—who were trying to flag parts of this problem as they were coming down the track and were not able to attract attention to some of the problems that were building up.

I notice in your statement, Mr. Gray, you say on page 7,

> Several high ranking officials of OMB told me personally in 1985 and 1986 that we were violating the deregulatory policy of the administration by asking for substantial increases in staff at the Bank Board.

Who were those officials?

Mr. GRAY. Connie Horner at OMB. She's now OPM director. And later Carol Crawford, who was at OMB. Both of them had the title of associate director.

Senator RIEGLE. Was there anybody else?

Mr. GRAY. Well, in the administration there were some who weren't following this very closely. I think if they had followed it more closely they might have been more careful with what they said, but some were saying that we were off the reservation. This came more from the Treasury than anyplace else.

Senator RIEGLE. But what you're telling us for the record is that you actively sought additional staff increases to try to monitor this situation and you were turned down by OMB. Is that correct?

Mr. GRAY. Repeatedly, and, Senator, if you will look through the 80 pages that I have submitted, you will find numerous references to this problem. I mentioned this in our testimony before the Appropriations Subcommittee. I mentioned it to other committees. It was a real problem and the biggest problem of all was that we were required to go through OMB. All parties involved advised us against trying to go around OMB.

Senator RIEGLE. I remember conversations that you and I had on this very subject at that time. We were trying to find a way to beef up the staff and were unable to do so.

Let me switch to an entirely different question. That is, as we work out this problem and as we go through our sense of the Senate resolution, which I hope we will draft with your help and others, and try to move quickly in the Congress this year, there will come into focus a central question about the future of the savings and loan industry. Do we need to have and preserve a specialized housing lending function in our financial service structure? That's certainly been the history of the savings and loan industry.

There have been all these changes that we've been talking about today, but looking forward in terms of meeting the housing needs of the country, is it important, in your judgment, to maintain a savings and loan industry, however revised, that's free-standing, not affiliated with the commercial banking system in a merged situation?

Mr. Janis, as I listened to your earlier comments, I felt that you were saying that you felt we needed to do that, but I don't want to put those words in your mouth. I'd like each of you to respond to that question, if you would, and why don't you start?

MAINTAIN A SAVINGS AND LOAN INDUSTRY

Mr. **Janis**. Senator, it's very popular these days to say that the securitization of the mortgage product obviates the need for a separate thrift industry. I just think that's hogwash, plain and simple hogwash.

The individual mortgage borrower in this country cannot compete with the General Motors and with the other big entitites for funds. They're out there issuing commercial paper and everything else. Home buyers have to have a separate system for mortgage finance.

Now if you'll look at the history of the civilized world, every civilized country that I've studied has a separate system, public or quasi or whatever.

Senator **Riegle**. Let me do this. In the interest of time, you feel strongly we do need to maintain it.

Mr. Pratt, what would be your view?

Mr. **Pratt**. I believe that the thrift industry has done the Nation probably a substantial disservice in the emphasis they've put on thrift and homeownership, the safeguard of American liberty. I think they've sold the Congress a bill of goods to a large extent. Mr. Janis and I have agreed to disagree on this for a very long time period.

Probably the major problem facing thrifts today is the fact that their mortgages are too safe, too liquid, and too fungible in the capital markets. I very much disagree with what Mr. Janis is saying. The markets have gotten very efficient and I think it's extremely difficult to make a living in that. I think legislation or action which tends to keep them focused in that direction against their economic interest, if their economic interests lie elsewhere, is going to be destructive to them, hurt the consumer, and that they will stay in mortgages because the good ones know how to make money there and not because Congress needs to tell them to do it.

Senator **Riegle**. Let me just ask one followup and then I want Mr. Gray's comment. That is, are you saying that if the savings and loan industry were in effect to end its principal focus on housing, the housing needs would be met just as well through some other means?

Mr. **Pratt**. Well, if you look at the tremendous concentration of thrift assets in California and California institutions have the right to pretty much be out of mortgages, other than some Federal IRS tests and that sort of thing, they stay in mortgages because they do a good job at it. I think you don't need to constrain them. I think they will serve thrift and homeownership to the extent that needs to be served, but that's just one part of the market. I don't think there's any evidence whatsoever to support Jay's contention they can't compete with General Motors. I think they compete with General Motors very well, thank you.

Senator RIEGLE. Mr. Gray.

Mr. GRAY. Well, it is true that spreads are very narrow right now. I returned to the industry and I know that and I know that you have to be very lean and mean if you're just going to concentrate solely on home mortgages and make the kind of money that's necessary.

I would have given you a quick, easy answer to this question 2, 3 or 4 years ago. I'm not ready to give a quick and easy answer right now. It's tough to make money in the thrift industry today and I guess the answer is, if you have to use these other kinds of instruments to make your money, then perhaps we're not really talking about the same kind of institution.

Senator RIEGLE. I hope to come back to that. My time is up.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

Mr. Janis, you suggested in your comments a minute ago that the FSLIC should close down the 300 sick S&L's by using the $20 billion available to it. Is that right?

Mr. JANIS. Well, I'm saying that they ought to focus their energy in the short run on those 300 S&L's. They are focusing on the tough, difficult ones and they could close over 300, yes.

Senator HEINZ. Yesterday, when Mr. Gould was before the committee, he said that in his view the FSLIC could not pragmatically spend more than the $20 billion that they have available for the next 3 years, that things were proceeding at as fast a pace as possible.

Would you agree with his assessment that the FSLIC is moving as fast as possible?

FSLIC IS DEALING WITH CASES AS FAST AS POSSIBLE

Mr. JANIS. No. I think it's a matter of how they do it. Closing down an institution is not the same thing as ultimately disposing of the assets. Those are two different things. You can close down. You can liquidate or maybe do a fast merger if you're lucky, but disposing of the assets takes time. But closing down is something that can be done quickly if you have the money up front.

Senator HEINZ. Mr. Pratt, how would you react to Mr. Gould's comments?

Mr. PRATT. I think we do need to close these. We also need to be careful about the way they're closed. I think we're overbanked and part of the problem in making money is that there's simply too many branches, too many banks, too many thrift outlets, that we're going through the cycle that laundromats and service stations go through, but it's an awful lot more painful to have a financial institution fail as compared with one of those.

So we need to take some of these facilities. We can't let the Government be sponsoring competition with healthy institutions by keeping sick institutions in business or propping up institutions that have no capital.

Senator HEINZ. My question was, how fast can we proceed? There's a sense in the industry and there's a sense from Mr. Janis that we should be going faster than we are.

Mr. PRATT. I think that's a tough question. Mechanically, it's difficult. And you also have to ask the question, how much of the agency is going to be directed toward doing other things? I honestly don't know.

Senator HEINZ. Mr. Gray.

Mr. GRAY. Well, I think it's hard not being there knowing all the facts, so let's put that on the table. But I would think that it's important—if you're trying to resolve cases by not closing them but by rather resolving them by bringing in outside capital, that's a worthy goal. The problem is there's not much real capital out there, in my opinion, to resolve these cases where the asset situation is so terrible. And I don't see in the future this kind of resolution being very helpful.

Senator HEINZ. What you're saying, as I understand it, is that it's wonderful if you can get new capital, but the people with the capital didn't make it by being stupid and paying more than the market will bear.

Mr. GRAY. Right. Exactly.

Senator HEINZ. If you liquidate a sick S&L, the properties they own are going to be available on the market for whatever the fair market value is. I don't know whether that's going to be 5 cents or 25 cents on the dollar, but it's going to be cheap and the people who are out there being asked to put up money know that. Isn't that right?

Mr. GRAY. I feel very strongly that the sooner we can get these institutions closed, the better and the less we're going to have to pay in the long run. By the way, the more it's going to help those who are currently having to compete in the money marketplace.

Senator HEINZ. Let me shift to a different type of question. One of the things that has struck me particularly about Mr. Janis and Mr. Pratt's comments is that they are much wiser men today than they were several years ago. Maybe even Mr. Gray is a wiser man today than several years ago. But he did propose certain things that were ignored both on the hill and downtown.

You're both smart men and you both have a career in public service and I'm wondering, is there some institutional handicap or failing that the Federal Home Loan Bank Board and the FSLIC labor under that makes it hard for our chief regulator and insurer—and the chairman is both—to come to grips with problems on a timely basis?

It's been proposed, for example, that a material contribution could be made if we separated them, as we have with the Comptroller and the FDIC. Maybe we should and maybe we shouldn't, but my question is really broader than that. Is there something about the nature of your job and its relationship to the industry, or to whoever is in power in Washington, that somehow forces or encourages a myopic or somewhat blinded vision on whoever has that job, or is it just bad luck and the fact that the agency is going through a very difficult period?

Mr. **Janis**. Do you want both of us to answer?

Senator **Heinz**. Let me start with Mr. Janis.

Mr. **Janis**. First, I don't believe there's any great structural problem that would have prevented us from dealing with some of this.

Second, I think it's important for regulators to remember that they are the head of an independent agency of Government responsible to the Congress and this is where I respectfully disagree with my good friend, Ed Gray, about the influence of the savings and loan league or whatever trade association. You're the head of an independent agency of Government. You don't have to listen to the administration. You don't have to listen to anybody but Congress and your own conscience.

And point three is, my failures were failures not of structure but perhaps of intellectual capacity to be able to have a clear enough crystal ball to think through what the implications of the future would be.

Senator **Heinz**. Mr. Pratt.

Mr. **Pratt**. I have long thought the structure was probably an advantage, but I begin to question that a bit. The advantage is that incorporates the Federal Reserve, the Comptroller and the FDIC in one agency for the thrifts. The disadvantage may be that it has historically brought the agency too close to its regulated industry and I have had the feeling that in fact the industry has historically been closer to the regulator than is healthful for the industry or the regulator. I had another point but I've forgotten it.

Senator **Heinz**. You think it would be better if the agency viewed itself more as the insurer than the regulator?

Mr. **Pratt**. Jay's point is extremely important. If you lose the dialog between yourself and the industry and some degree of adversarial consideration, I think you greatly weaken both the agency and the industry. The industry's short-run desires are not always productive and the regulator's short-run ideas may be counterproductive. There needs to be a check and balance. There needs to be separateness. I remember in the crisis of 1981 a large group of the most powerful California thrifts—we were in a meeting and they were vociferously advocating an accounting system which would have massively misstated accounting statements for years. They were panicked and the regulator needed to be an independent body to resist that situation.

Senator **Heinz**. I'll get to Mr. Gray in a second, but just quickly, I'm not quite sure where you come out.

Mr. **Pratt**. I think I've forgotten the question, Senator.

Senator **Heinz**. The question was, is there a structural problem and what would you do about it if there is?

Mr. **Pratt**. I don't think there are structural problems other than what we've just discussed. Second, I think the short tenure has been a problem. For instance, the things we were considering in the resolution of the FSLIC I think by having the turnover of chairmen it takes some time to start it up and at times these can be critical junctures and there simply can't be total continuity the way the agency turns over with the chairman bringing senior staff that he relies on. So I think that is structurally a problem and if it happens at the wrong moment can be a critical problem.

Senator **Heinz**. Mr. Gray.

Mr. GRAY. I think that's true. With respect to structure, as Dick points out, you have all of the components of regulation and insurance in one agency, the Bank Board, compared to the commercial banking industry.

But I would say this. I can't agree with Jay on this, and I'm saying that out of personal experience. The regulator needs the Congress to help him, particularly in terms of considering the legislative packages that you send up. The very powerful organized thrift industry is often working at cross-purposes with the regulator, and carries a great deal more weight with the Congress. Without congressional support, I'm not sure that Jesus Christ could withstand all the pressures on the regulator.

Senator HEINZ. I'd like to pursue that, but my time has expired.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman. Mr. Chairman, I ask unanimous consent that my opening statement appear at the appropriate part of the record.

The CHAIRMAN. Without objection, it will be printed in full in the record.

DEREGULATION COULD HAVE BEEN SMOOTHER

Senator SHELBY. All three of you gentlemen bring unique qualifications here and all three of you have been very involved at successive times in the operation of the Bank Board and it's my understanding of Mr. Janis' testimony basically, Mr. Janis—you correct me if I'm wrong in the interpretation—that you blame a lot of the problems that the industry has on the haphazard way that deregulation occurred so soon, so fast, maybe deregulation for deregulation's sake, rather than a real thought out plan that would work.

Mr. JANIS. Precisely right, Senator.

Senator SHELBY. Now, Mr. Pratt and Mr. Gray, both of you have served there. Do you agree with Mr. Janis' overall view?

Mr. PRATT. Well, I think it's a wonderful view in hindsight and perhaps that is——

Senator SHELBY. What we're doing now is a post mortem, aren't we, in a sense?

Mr. PRATT. Sure, in hindsight there is a different approach that would have been much more helpful. Whether it's realistic to assume that any set of institutions could have had the foresight to do it that way rather than through disjointed incrementalism may be very unrealistic would be the only caveat I would add.

And I would also say that if the loss is $50 billion today, I believe the consumer has still been the major beneficiary. If you look at the way Congress and the regulator has protected middle America and enhanced their ability to be treated fairly in our financial markets, I think deregulation of rates had to occur and that it has helped the consumer even if the cost is $50 or $75 billion.

Senator SHELBY. Mr. Gray.

Mr. GRAY. Well, I agree with Jay that it was haphazard. The tragedy of all this was——

Senator SHELBY. Did it come too fast?

Mr. GRAY. Well, the tragedy was that the regulatory apparatus was in no way prepared for it. I became chairman a few days after the Bank Board had adopted the enabling regulations to put into effect Garn-St Germain. Frankly, the apparatus was not even partially prepared to deal with these changes. The idea of trying to regulate in those circumstances was impossible anyway and, of course, it was made much worse by the fact that we didn't get any cooperation from OMB when we needed their help desperately, and we also didn't get help from other quarters.

Senator SHELBY. We know what's happened. All three of you have given us a shorthand rendition of this. We've sat in the committee. Both Senator Garn as former chairman and Senator Proxmire as the present chairman have spent a lot of years on this committee. Do you three gentlemen believe it's very important as a premise for us to make public policy here in the Banking Committee and ultimately in the Congress that, No. 1, we should have a sound banking system for the American people and bailing out the thrifts or making the thrifts healthy, however we do it, should be the No. 1 issue before us?

Mr. GRAY. Are you asking me?

Senator SHELBY. I'm asking all three of you. Mr. Janis?

Mr. JANIS. Yes, sir, I certainly do. Our economy depends on a sound banking system. I think we all know that.

Senator SHELBY. And the thrifts is a part of this.

Mr. JANIS. A very important part.

Senator SHELBY. And it's playing a different role than what we envisioned it would in the 1930's, is that right?

Mr. JANIS. No, sir, and I think there's a misconception here.

Senator SHELBY. OK. What was that?

Mr. JANIS. There was a period of time in 1981 and 1982 when we thought that thrifts would diversify and get into all kinds of other things and homogenize and begin to look like banks. That simply hasn't happened.

The thrifts are still very heavily mortgage lenders. They are still originating lots of mortgages and they are still the bedrock of the American housing financial system.

Senator SHELBY. Mr. Pratt.

Mr. PRATT. Yes, I think you need to address the problem. This is like an apple that is bad in the basket. If the issues aren't addressed—Jay is simply wrong in the fact that the institutions haven't changed. For instance, today they've borrowed $250 billion in the capital markets and other places. They are much more sophisticated. They are much more full service. They are still the primary provider of mortgage credit. That doesn't mean they haven't changed.

Senator SHELBY. Let me ask you gentlemen this. Secretary Gould yesterday was talking about a little numbers game that's been going on right here in the committee—those are his words—as to what it's going to cost to make the thrifts healthy.

The CHAIRMAN. Senator Shelby, let me just interrupt. There's a roll call going on right now. Why don't you continue and conclude your questioning and then recess the committee and we'll come right back after the vote.

Senator SHELBY. The chairman, as all of you know, hasn't missed a vote in 20 years. We don't want him to miss one now.

Senator **Heinz**. Senator Shelby, would you yield for a unanimous consent request?

Senator **Shelby**. I will do that.

Senator **Heinz**. I ask unanimous consent that my statement appear at the appropriate part of the record.

Senator **Shelby**. Without objection, so ordered.

BEST ESTIMATE OF COST

What is it going to really cost—I'll start with you, Mr. Janis—in your best judgment, to take care of the problems that we find ourselves in with the thrift industry? Last year we were talking about $5 billion and we came forth with that. I've seen people at the table here before the Banking Committee have estimates anywhere from $15 billion to $80 billion. Some people say it's going to cost $100 billion. No one knows.

But in your capacity, all three of you have unique backgrounds—what is your best judgment? We'll start with Mr. Janis—as to what it's going to cost if it costs the taxpayers or if it costs the thrifts—what is it going to cost to keep the thrifts healthy and to keep the confidence of the American people?

Mr. **Janis**. Senator, the truth is, no one knows the right figure and I think that anybody that tries to give you a figure and tries to——

Senator **Shelby**. It's a judgment.

Mr. **Janis**. And top somebody else's figure is just shooting for a headline, and I deplore that kind of thing.

Senator **Shelby**. We're looking for the truth, not a headline.

Mr. **Janis**. Right. I think I can say this safely. It is higher than what it is that the Bank Board has in the special assessments and the other funds that are available to cover it. It is higher than that and, therefore, when you collect all the moneys that are available and you bleed the industry to the point where they can't be bled any more—I think they're just about there now, by the way—you're going to have to use Federal funds, in my judgment, and that's the bottom line on your question.

Senator **Shelby**. That answers my question. Mr. Pratt.

Mr. **Pratt**. For the headline writers, the last name is spelled P-r-a-t-t, and I think it probably is in the $50 to $75 billion range.

Senator **Shelby**. Mr. Gray.

Mr. **Gray**. My judgment is that it's somewhere in excess of $40 billion.

Senator **Shelby**. Last year as we all know we came up with $5 billion. The suggestion that Mr. Janis made a minute ago, I think it makes a lot of sense. How can you expect the healthy thrifts that are out there—and some of them are well run and some are doing well—expect to pay for the bailout of the people who have made mistakes, who are going insolvent? Why should these people be made to carry that load and can they carry that load?

Mr. **Janis**. Senator, this came up yesterday, this question of how much could the thrifts pay, and no one quantified it and I'd like to take a shot at it, if I may.

Senator **Shelby**. Go ahead.

Mr. JANIS. The present premium structure, special and regular assessments, runs around 21 basis points combined. If you look at the ROA—that means return on assets—of the healthy institutions, the solvent institutions, the ones that are making money, on a pre-tax basis, you're talking about probably 50 ROA. So right now assessments are taking roughly 40 percent of the pre-tax profits of the business.

Now I submit that if the industry were required to pay more than 40 percent of its profits, to recoup that they might try to get into some risky activities.

Senator SHELBY. Which would be self-defeating.

Mr. JANIS. Self-defeating, counterproductive, and all those kinds of things. So I think we're pretty darn close to the limit. Senator Proxmire made the point yesterday that the special assessment alone—that's part of that 21 basis points—runs about 25 percent of profits. I think Senator Proxmire is correct and I think they're about at the limit now.

Senator SHELBY. Mr. Pratt.

Mr. PRATT. The first thing that needs to be recognized is that the insurance agencies aren't insurance agencies and, therefore, one need not look at the revenues versus expenditures. They are simply revenue and expenditure arms of the Federal Government.

I think that the assessment now is probably at a maximum reasonable level. I think you need to ask the question, do you lower that level or should the banks be brought to that level. I don't see a basis for the very substantial differential taxing that occurs at this time between the two entities, but I think it would be counterproductive to look for more funds from the thrift industry.

Senator SHELBY. Mr. Gray.

Mr. GRAY. I think the question is how long the special assessment authority is extended because that will determine how much money ultimately comes from the industry. Then the question is, how long should it be extended, under what circumstances, and at what rate.

But there's another cost. I don't think you can only talk about dollar costs. The Congress has to make sure that in the future this doesn't happen again. What the Congress has to do is to make sure that we have the kinds of principles and operational criteria and discipline in effect. That's going to be a cost also. It may not be measured in dollars but it has to be a cost and it has to be factored in.

Senator SHELBY. What's the plus side, if any, of dragging out the so-called bailout, other than the lack of money to take care and close down and merge other thrifts that are insolvent? What is the cost? It seems to me that there's a cost of confidence out there with the American people because some people say, well, is this institution going to make it? I know we have the savings and loan and we got the insurance up to $100,000 for depositors and we guarantee them this and we've had the sense of the Senate and the sense of the House in dealing with that. But the bottom line it seems to me is the sooner that we face up to this problem and not just let the cancer eat into us over and over, because if you let the cancer stay with us it will kill the whole industry.

Mr. GRAY. Well, I'd like to take that first, if I may. I'd like to say that if you ask the depositor what kind of choices he has and would make—for example, if your taxes went up by so much in order to maintain confidence, what would you think about that? That's part of the question that we're not asking because every depositor is a taxpayer. I would just caution that we have to take that into account.

Senator SHELBY. I understand that. Mr. Janis.

Mr. JANIS. In addition to the $7 billion or more per year that it's costing us to keep open the insolvents, the factor you mentioned on confidence is vital. It is costing the savings and loan——

Senator SHELBY. That's central to the whole thing.

Mr. JANIS. Yes, sir. And you can put that in dollar terms. You can quantify that because the business is paying between 50 and 100 basis points more for deposits than the commercial banks. This is, the healthy, good savings and loans are paying more than 50 to 100 basis points more than banks for deposits.

Senator SHELBY. I share your concern. I'm going to have to recess the hearing and Senator Proxmire will come back. Thank you, gentlemen.

[Recess.]

The CHAIRMAN. The committee will come to order.

Chairman Gray, there was about a 1-year delay in implementing the growth and direct investment regulations from the time they were first proposed by the Bank Board.

How many additional billions of dollars of losses can be attributed to that 1-year delay?

Mr. GRAY. Actually, that's not the case, Mr. Chairman.

The CHAIRMAN. There was not a 1-year delay?

Mr. GRAY. No. What we proposed in February 1984 was to phase-out of 5-year averaging. There was no growth regulation at that time.

The CHAIRMAN. Well, 5-year averaging was certainly one of the recommendations. How long a delay was there for that?

Mr. GRAY. We implemented the phase-out of 5-year averaging in December 1984.

The CHAIRMAN. But what was the delay before that was adopted?

Mr. GRAY. You mean when 5-year averaging was completely done away with?

The CHAIRMAN. That's right.

Mr. GRAY. That was the fall of 1986.

The CHAIRMAN. So that was a 1-year delay. You recommended it in September 1985 and it was adopted in the fall of 1986. Am I wrong or right about that?

Mr. GRAY. If you call the 5-year averaging the growth rate—if you make that the same, yes. But I would just say we didn't consider it that way.

The CHAIRMAN. Well, my question was not about that. I think your recommendation was excellent and putting it into effect was desirable, but my question was how much money was lost roughly—can you make any kind of estimate—in that intervening period?

Mr. GRAY. I couldn't make an estimate and I'll tell you why I couldn't. I want to be responsive, but if we had adopted the brokered funds regulation that issue would be moot because the brokered funds regulation would have had the same result as the growth regulation.

I don't know how you would—even if you didn't consider the brokered funds regulation—how you could estimate the cost. Certainly it would be substantial.

The CHAIRMAN. How much support did you get from the Treasury and OMB on that initiative?

Mr. GRAY. Well, we begged the Treasury to support our brokered funds regulation and, of course, we got just the opposite. So on that proposal we got absolutely no support whatsoever.

With respect to the growth rate, we did get a letter from the Secretary; however, we had two regulations at the time. The direct investment regulation was ignored—support for our direct investment regulation was completely ignored by Treasury. They took no position, when we needed their support.

The CHAIRMAN. Was the lack of support a factor in the delay?

Mr. GRAY. No.

The CHAIRMAN. It was not.

Mr. GRAY. No. I was too independent for that.

The CHAIRMAN. Chairman Janis, the latest projections of the Bank Board show the continuation of the special assessment for the next 10 years at a total cost of $18 billion. Can the healthy portion of the industry pay the special assessment for the next 10 years without serious damage?

CAN INDUSTRY AFFORD THE 10-PERCENT ASSESSMENT?

Mr. JANIS. No, sir. You said yesterday very correctly that it's about 25 percent of their earnings. If you combine that with the regular assessment, it runs about 40 percent of their earnings. You reach a tipping point, Senator, where if you're taking that much of their earnings you can go off the edge and they can do risky things to try and make back the stockholder value. Senator, I think it's a dangerous thing. I think we have to begin to think to phase that out.

The CHAIRMAN. And isn't there another problem, too, that while the average would be 25 percent, there would be hundreds of S&L's who would be put from a profit position to a loss position?

Mr. JANIS. Absolutely, without question.

The CHAIRMAN. Mr. Pratt, do you agree with that?

Mr. PRATT. I think it's a relatively complex issue. I don't know whether the industry could afford that or not. Clearly, if you're going to lower those costs you've got to get the insurance agency out of the insurance business. You've got to change the rules of the game so that it isn't an operating insurance company and I think you clearly need equity between the banks and the thrifts. There's no reason that thrifts should be paying twice what banks are paying.

The CHAIRMAN. So you feel that if it continues for another 10 years and brings in $18 billion that it could have a serious adverse effect on the industry, is that correct?

Mr. PRATT. Mr. Chairman, I would like to follow on one of Jay's points. I think the really scary thing is that the healthy side of the industry is not making a lot of money. It isn't that 21 basis points is necessarily a huge amount. It's the fact that the industry is not making much money and it could well be more than 100 percent of their income even for the GAAP solvents. So that's somewhat of a separate issue.

The CHAIRMAN. You would agree that there would be many S&L's that would be underwater, would lose money?

Mr. PRATT. Certainly. It approaches the average income of the healthy industry.

The CHAIRMAN. So you would agree with Jay that this is something we should phase out as soon as possible. We shouldn't let it continue for 10 years, is that right?

Mr. PRATT. Well, I think you have to make the decision as to how things are funded, but I do think that it's a massive and material burden on the industry and one that does exacerbate their operating problems.

The CHAIRMAN. Chairman Gray, do you agree with that?

Mr. GRAY. Yes.

The CHAIRMAN. Then I take it that all of you would agree that they obviously could not pay an additional amount. In other words, some people say we have an option of either a taxpayer bailout if this continues or an additional assessment for the industry. I take it from your responses here there not only shouldn't be an additional assessment, but if this is continued for the 10-year period that Secretary Gould described yesterday, that this could be very, very harmful to the industry, including healthy S&L's.

Mr. JANIS. Senator, if you accept my theory that you increase the risk by having them pay this much, then the simple conclusion is that if you have them pay more it would just make matters worse and the taxpayer bill that would have to be footed would be larger than what it's going to be as it is.

The CHAIRMAN. Chairman Gray, in your prepared testimony you discuss a number of initiatives you took in 1983 and 1984 to stop the growth of asset quality problems that you saw the thrifts getting into. Among other things, these initiatives included regulations, first, to control brokered deposits; second, to impose controls on direct investment by thrifts; and three, to put the growth limits on thrift without adequate capital.

Can you give us the position of the administration on each of these regulatory initiatives and your understanding of why the administration adopted the position it did on each? First, on brokered deposits, what was the administration's position?

Mr. GRAY. Well, I don't think the administration had a position but Treasury had a position and a very strong one. There was a great deal of acrimony, as a matter of fact, on this issue and the Treasury frankly did everything it could—I spent one evening, for example, 7 hours talking to Deputy Secretary McNamara just before we proposed the regulation. I had been at the White House in 1982. I was new to this job and I was testing my own independence at the time and I told him to go jump in the lake and that we were going to do what we wanted to do.

The CHAIRMAN. That was on brokered deposits?

Mr. GRAY. Yes. Now the other on direct investments, the administration never gave me their support, ever. And the other one was the growth rate?

The CHAIRMAN. Limits on thrifts without adequate capital.

Mr. GRAY. Well, I did get a letter of support for the growth regulation after I begged for it, yes.

Senator RIEGLE. Mr. Chairman, I know your time is up. Could I just ask one followup on this point.

The CHAIRMAN. Let me say, before you ask that followup, let me ask permission from Senator Hecht. He's the next to question.

Senator HECHT. Ask it and then I have just a couple of questions.

Senator RIEGLE. I'll be very brief and I appreciate the Senator's courtesy.

When you say that you said "Go jump in the lake," you must have said that to something he said. I take it that what he was saying was, "Don't go ahead with the regulation."

Mr. GRAY. Well, sure. They were saying more than that. They were trying to persuade me not to do it and I was becoming more and more recalcitrant.

Senator RIEGLE. A 7-hour meeting?

Mr. GRAY. No, no. This was on the telephone.

Senator RIEGLE. A 7-hour telephone call?

Mr. GRAY. That's right.

The CHAIRMAN. It wasn't long distance.

Senator RIEGLE. It sounds like there was a long distance between them. That's incredible. I thank the Senator.

The CHAIRMAN. Thank you, Senator Riegle.

Senator Hecht.

Senator HECHT. Seven-hour telephone call long distance, no wonder the Government is broke.

Mr. GRAY. Well, they were two blocks away.

Senator HECHT. I've got one question I want to ask all of you but before I do, Mr. Janis, you were saying about deregulation came too fast and everything. That was a management prerogative at that time. They could accept certain parts of it or certain parts they didn't have to accept. How can you blame the Government or the Senate for that? That was strictly a management decision.

NO ONE FORCED THE S&L INDUSTRY TO DEREGULATE

Mr. JANIS. I blame all of us for that, Senator. Let me make that clear. The deposit deregulation was too fast. The DIDC—do you remember that institution that was created by Congress in 1980? They went hell bent to try and deregulate deposits ahead of the congressionally mandated schedule. In fact, they did deregulate in 4 years instead of the 6 that Congress had laid out.

We never should have started the deposit deregulation until we had deregulated the asset side and had ARM lending. On the asset side, I think that was too fast—well, I'm not sure it was too fast as much as I think we should have restructured the deposit insurance system to have taken care of the risk that were added by the asset deregulation.

Senator HECHT. Many savings and loans and thrifts did very well by that. That was strictly management. I mean, if you weren't able to do it, nobody told you you had to do it, that you had to deregulate. Many savings and loans, the new powers that were given, no one told them they had to do that—checking accounts and so on and so forth.

Mr. **Janis**. Senator, when the State of California gave virtually unlimited powers, that made the charter in California the most valuable piece of paper in the world for a financial institution. Here you had a charter with unlimited powers and you had the Federal backing on it. Now, my goodness, look at the flies that were drawn to the honey pot when that happened, and look at the kind of people that came into the business, and look at the kinds of investments that they made that Ed Gray spent several years trying to stop.

Mr. **Gray**. And let me just add, this was done in 1982. Remember this. The organized thrift industry did nothing—did not lift a finger to oppose that legislation—nothing.

Mr. **Pratt**. Which legislation?

Mr. **Gray**. The California legislation.

Senator **Hecht**. Well, then, do you feel that State laws should be tied into Federal laws if the Federal insurance is there?

Mr. **Gray**. I think if you have one insurer, you'd better make sure that you can underwrite the risk. If you can't underwrite the risk—forgive me—let me call it, for purposes of this discussion, what it is—the FSLIC is a group insurance plan. It's a group plan. And we tried very hard to price the risk and to cause institutions that went beyond the Garn-St Germain Act to pay supplemental premiums. We weren't successful because the organized industry opposed us on that, too. It killed that bill.

Senator **Hecht**. Should the State insurance laws for thrifts be the same as the Federal if we have Federal deposit insurance?

Mr. **Gray**. Yes. I believe so.

Mr. **Janis**. Senator, may I say something quickly on that? There's a value to the dual system. We never would have had an ARM in this country if we hadn't have had that variable rate in California 5 years earlier. So let's not get rid of the dual system. Let's put on a moratorium—let's allow the PSA's out there to determine if the track record of an institution is adequate to use excess powers and if an institution has the capital. And if that's not the case, a State could ante up to pay for the extra risk. Let's not get rid of the dual system as we try to sort through this problem.

Mr. **Gray**. I just have to——

Senator **Hecht**. Then I have to ask one question before my time is up.

Mr. **Gray**. Go ahead. I defer to a U.S. Senator.

Senator **Hecht**. No. Let's hear what you've got to say real fast.

Mr. **Gray**. No. Go ahead.

Senator **Hecht**. OK. Everyone is pointing their finger, we're going back and saying this one made a mistake, it was Congress, it was California or it was this one. Let's forget that. Let's look to the future.

Now politics has been a big part of this whole equation right here and in this political year right now the promises that are being made, unfortunately by both parties, are quite a bit, which means the money markets are already getting nervous and interest rates are beginning to move up.

What will happen if we have a two point rise in interest rates within the next year?

Mr. **Pratt**. Well, at the present time the thrift industry is essentially breaking even on interest income versus operating costs for GAAP solvent thrifts. As you know, the portion of GAAP insolvent thrifts to total thrifts is increasing at the same time. So a massive move like that would put us into something like the 1981–82 circumstance. And I would think that the industry in general is much weaker than it was going into 1981. It would probably affect—half of the remaining industry would probably be incapable of operating if that were to continue for 24 months.

Senator **Hecht**. Mr. Chairman, could I ask the other two to comment on this point?

Mr. **Janis**. In general terms, I agree.

Senator **Hecht**. A disaster?

Mr. **Janis**. I agree with what Mr. Pratt said. It would be harmful.

Mr. **Gray**. I would say it would be very harmful.

Senator **Hecht**. Thank you very much.

The **Chairman**. Senator Garn.

Senator **Garn**. Thank you, Mr. Chairman.

DEPOSIT INSURANCE

Mr. Janis, let me go back to you again because of the timeframe. At the same time Chairman Proxmire and I were sitting in this room and removing regulation Q, I voted without any reservations whatsoever to increase deposit insurance to $100,000 and it was $40,000 at the time. There were various suggestions floating around the table as to the amount of the increase—$80,000 was one of them. I supported $100,000 because we were very worried about depositor confidence and felt that the best way to prevent a massive run on institutions—not only savings and loans but banks—in that time frame was to say, "hey, don't worry about it."

In hindsight, I question that determination by myself and the rest of the Congress. I wondered if you believe it was raised too high and, as a result, some institutions said, "hey, we can do this, we can do that, we can do something else and the feds will bail us out up to $100,000?" Did that act of raising it so much higher, from a $40,000 guarantee to a $100,000 guarantee encourage the creation of the risky schemes that some of the State-chartered institutions went into?

Mr. **Janis**. No, sir, I really don't think so. I recall that I got a call from the staff director of the committee at that time indicating that the committee was thinking about the possibility of raising it and they wanted to know what we at the Bank Board thought. And I had my staff work on it, and we did an analysis which showed that there really wasn't going to be significant excess risk for the insurance fund in going from the $40,000 to $100,000.

Now maybe the analysis was flawed and maybe in hindsight it shouldn't have been done, but that was the analysis. And I probably—I don't recall specifically—testified before this Committee based on that analysis that I favored it. I did then, based on the analysis. I would not think that we should reduce it now because I think there could be some real liquidity problems if we did.

Senator **Garn**. Well, that's not a question. Politically it's not possible to reduce it and I relied on that same analysis. My point is not what we did then. I have been around when you haven't and I have heard that comment from literally dozens and dozens of institutions and people. My own opinion would be, again in hindsight, that we raised it too much. We solved an immediate problem and rushed to an immediate decision and created at least partially a longer-range problem.

Mr. **Janis**. It goes back to what you said before, Senator, about the enormous competition and the disintermediation and the money market mutual funds, Wall Street, and insurance companies and so forth. There was a lot of justification for it and since the analysis didn't indicate a lot of risk, I think that was a wise decision at the time.

Senator **Garn**. Well, based on that same set of circumstances, my vote would be the same now. I'm talking in terms of hindsight and what has taken place.

Mr. Gray, there has been a lot of talk today about closing down institutions faster. I don't think anybody would disagree that the faster we can get these insolvent institutions out of the system, the better off we are. Everybody agrees with that, but all three of you have been chairman and I would ask each of you why didn't you close them down faster? The question is being asked today. OK, why didn't each of you close them?

CLOSURE OF INSOLVENT INSTITUTIONS

Mr. **Gray**. Well, I'd like to start. Near the end of my term, of course, we had run out of money literally and so we couldn't close any more down. That's why we needed the recapitalization.

Earlier on, no one was complaining about the rate of closings. It was a matter of how to best manage our money. Had we not taken time to find the least costly resolutions, you in the Congress might have been quite critical of us.

I think the problem is different now. The problem is that we have all of these hopelessly insolvent institutions that can never ever be resuscitated. They were gone in 1985 and 1986, but there were too many of them. That's why we established the management consignment programs to try to deal with these problems. We could have run out of money by doing liquidations very, very quickly, but now the situation is different.

Senator **Garn**. Well, that's part of the problem. You were out of money and why were you out of money?

Mr. **Gray**. We were out of money because we were doing our job of closing institutions and paying assistance where necessary, as little as possible wherever possible.

Senator **Garn**. Well, my time is up. Let me go further and answer my own question. I still have great heartburn over the House of Representatives' decision and obviously I agree with Jay—there are lots of parts to this problem. But I still am angry nearly 2 years later. If in October 1986 you had the tools, which meant the money, to start closing down institutions as we got into the bigger problem, it wouldn't have solved the problem, but I think it certainly would have minimized it. And the House held that $15 billion FSLIC recap hostage for a housing authorization bill. That's fact, not an opinion. It's simply a fact of life. And that still bothers me, that a body of the Congress in light of the Senate passing it—we all agreed on this side and sent it over to them repeatedly in the last 2 or 3 days, and the answer was constantly, "No, unless you accept a housing authorization bill." I don't know that I've ever seen a more irresponsible act by Congress.

I didn't have any problem with passing a housing authorization bill, but that was hardly the time or place to hold something—when you had a problem that was this serious—$6 million a day was the estimate at that time—that was hemorrhaging, but we went out of session without passing that.

Mr. GRAY. I remember very well, but I would also say the following. We can't forget the fact—and I remember, I called one of the major trade associations and I said, "Why is it that you keep dragging your feet? Why is it that nothing is happening to spur on the Congress to get this done?" Well, I knew what the answer was.

Senator GARN. Well, the Senate resisted that pressure of the League and passed the FSLIC recap. The House did not.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. I want to try to move through a few things very quickly in the time I have. I want to come back to your comment on the 7-hour telephone call that spanned two blocks.

You said you thought there might be something personal about it. What?

Mr. GRAY. I really didn't know what was driving this strong opposition to our regulation. It was mysterious to me. We had a problem. I thought I made the case very well.

Senator RIEGLE. But you must have developed some judgment or theory as to what was going on. These were the brokered deposits arguments, right?

Mr. GRAY. Well, I can't know for certain why this was happening.

Senator RIEGLE. You look and sound like a guy who has a pretty good idea, though.

Mr. GRAY. Well, I think I have an idea but I can't prove it.

Senator RIEGLE. And you can't share with us what you think was going on?

Mr. GRAY. Well, the Secretary at the time, for whatever reasons, obviously must have had some level of reservation about this. I don't know. I could only surmise and I don't think it serves much purpose to surmise.

Senator RIEGLE. We're talking about the Treasury Secretary?

Mr. PRATT. Mr. Riegle, might I just comment on that?

Senator RIEGLE. If you can do it quickly.

Mr. PRATT. It was very precipitous in the DIDC meetings, the meeting where brokered deposits were authorized was really pretty bizarre and there was very little staff work, in my opinion, done. The main driving force was Secretary Regan at that time. I thought that the action we were taking wasn't adequately thought out and I was generally pro-deregulation, but I thought it was a very strange circumstance, and while the Secretary could sometimes be in error, he was seldom in doubt, and this was one of those issues I think in that regard.

Mr. **Gray**. In any event, the important point here is that I couldn't have found out directly from him anyway because he never chose to return my phone calls.

Senator **Riegle**. Well, a 7-hour phone call is really pretty amazing by itself.

I'd like to make two recommendations, Mr. Chairman. I think we've heard enough yesterday and today to be on sound ground to try to develop a sense of the Senate resolution that addresses some things that we can do to immediately to try to stop the hemorrhaging, and I'd like to suggest that as a committee we go to work to see if we can draft such a sense of the Senate resolution.

I also think we should move the Graham-Sasser S&L commission idea. That require the Congress to enact it as a matter of law. I think we should try to accomplish that at the same time.

I'd like to suggest that you, Mr. Janis, just as a starting point, take your list of ideas, and if we could have Mr. Pratt and Mr. Gray give us their formal responses for the record as to those that they would support and those that they would disagree with and others that they might suggest, so that we at least have a collective judgment from the three of you as to what might go on that sense of the Senate resolution.

Let me ask one other thing.

The **Chairman**. Before you get away from that, we'd like to have that as soon as possible. I don't know if you gentlemen could do that today, but as soon as you can. You responded in part when I questioned you on that. We know roughly what your position is, but you take Jay's recommendations and just say yes or no down the line, if you could.

Senator **Riegle**. And any additions that you might suggest.

Mr. Pratt, let me ask you this. If we're going to line up Federal deposit insurance with Federal granted activities and try to shear off the State activities and handle those separately, I'm trying to conceptualize how that might be done. I don't think you can do that overnight. You made the point that you would have to do that over a period of time and I agree with that.

But I'm wondering if you have in mind a model in which there is a transition period. Maybe if a State develops a separate insurance fund to cover activities, or maybe the activities go into a separate subsidiary, or maybe there is some kind of a fire wall arrangement as we're talking about now between banks and securities activities, so that we don't have leakage through to the Federal deposit insurance. Would you say that somebody that has become different than the traditional savings and loan ought to come on over into the FDIC?

How would you envision resolving the anomalies in States like California?

Mr. **Pratt**. I think you're going to find that as you figure out how to pay the bill for the present problem you're going to have to do major restructuring to keep it from being the same problem 5 years from now. I think that's going to be fairly comprehensive and I think it needs to be, first, the fundamental question of what insurance is going to be and if we're going to put sufficient capital requirements and other factors that it again steps very much into the background as a moral certainty sitting behind the operation of these institutions it becomes less of a problem.

I think you would need a substantial phase-out period to the extent you were going to prohibit these. You may choose to let federally chartered institutions move in some of those directions with adequate capital safeguards, maybe moving some of them from both States and federals into holding company activities and this type of thing. I really think it needs to be a comprehensive examination of the whole asset structure.

Mr. GRAY. I think we ought to look very carefully at that.

Senator RIEGLE. Well, I would not want it thought that I was suggesting anything other than looking very carefully, but I think we'd better start framing the issue. I'm hearing consensus around here saying let's line up Federal deposit guarantees with federally granted operating authorities. And if you're going to make that dividing line, then we've got to figure out how we take today's world and fit it into that.

Mr. PRATT. What I was saying, Senator, is some things may move in different directions over the line. It may be that some of the Federal authority—the States have proven that some things can be done well and fit within the scheme and some things can't and so on.

Mr. JANIS. Senator, I don't know if you heard my point, but let's not throw out the whole dual system.

Senator RIEGLE. No, I heard that and I don't know that there's a desire around here to do that, but the question of how we square the insurance system issue—maybe that's something the commission should look at, Senator Graham.

Mr. JANIS. Let me suggest this. Let your resolution talk about a moratorium and let the Federal Home Loan Bank Board put a moratorium through an interim final reg, and that will stop it immediately. And let the commission deal with the bigger question of the dual system and how to structure it.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman. I apologize that I was attending another meeting and missed what I'm certain was very constructive discussion.

My sense is that there are several fundamental problems for this industry, one of which you've just been discussing, and that is the mismatch between the incentives that have come from deregulation and the federally insured safety net against much of the risk that those deregulated powers have induced.

A second is how to stimulate new capital into this industry so that there is a greater cushion of equity between the actions of the institutions and the Federal insurance fund.

What would be your recommendations as to what could be done in order to make this a more attractive industry for new capital flows?

RECOMMENDATIONS TO ATTRACT NEW CAPITAL

Mr. Pratt. If I might start on that, first, let me give you a little perspective on new capital coming in to solve FSLIC problems.

If we assume those problems are let's say $60 billion, I would estimate the new capital that might come in would be in the range of $10 billion. So we're going to get about $1 of private capital into these really troubled institutions for each $7, $8, $9, or $10 of public capital. That needs to be kept in mind.

Second, I think this deposit insurance is extremely valuable and to the extent we give it away and let institutions expand without capital, it greatly cheapens it and it greatly reduces the amount of private capital that will come in seeking that type of charter and it massively increases the amount of examination and supervision to try and keep those operations in line.

So I really think you need to get to a point where there is some rent associated with the opportunity to offer deposits in order to get that capital in and to reduce examination and supervision problems.

I think without capital there is no number of examiners that will contain the problems and that in fact we will reduce ourselves to a bureaucracy that is paralyzed.

Mr. Gray. Let me add, I think we have to have a capital standard that people can see and look to. I'm distressed, for example, that a relatively modest approach to increasing thrift capital requirements has, by action of the current Board, been made weaker. When we tried to move the industry to 6 percent regulatory capital we tied it to industry profitability. The difficulty is that we have a new calculation now that includes 500 or so GAAP insolvent institutions. So it's hard to see us getting to 6 percent until some time in the next century.

But I would say capital has a way of breeding capital. Many in the industry choose to ignore the fact that, for regulatory purposes, you can increase your capital also by shrinking.

Senator Graham. I guess Eastern Airlines maybe is trying to implement that strategy.

Mr. Gray. I just don't want anybody to forget in this discussion that one way to increase capital is by shrinking.

Mr. Janis. Senator, three things. First, FSLIC has got to do deals faster. That's the biggest single deterrent now to getting capital into the system. Second, I think we've got to think about some policy changes as to who can enter the business. These are policy changes at the Bank Board. Maybe the time has come to think about new entrants into the business, new types and categories. And third, I think the thrift charter enhancement idea can be looked at provided the activities aren't risky, but I think we have to be very careful about thrift charter enhancement. There may be some areas there that make sense, too.

Mr. Pratt. Senator, I would only say that the new entrants aren't the only problem. I think if you look at the last ten chairmen of the U.S. Savings and Loan League maybe half of those have experienced difficulty and I assume that they were exemplary citizens probably in your estimation.

Mr. **Janis**. By new entrants, I'm talking about major retailers. I'm talking about insurance companies. I think you're talking about something different, aren't you, Dick?

Mr. **Pratt**. That's what I'm talking about in terms of the policy changes. The question is how do we get more capital into the business and I think that's one of the aspects.

The **Chairman**. Mr. Janis, you made a very impassioned and very appealing statement to begin with talking about all the different groups that were to blame here. You said the blame should go to Congress, to the regulators, to the industry, to the administration, and so forth.

Yesterday, Senator Riegle made what I thought was the best statement of the day when he said there's only one group who are paid to do one thing, and that's to regulate—that's to regulate this industry. As you know, the Congress is very loose oversight. That's no alibi. We should do much better than we do, but we have many other things to do on this committee. We have many other committees to sit on. None of us are experts in this area. The administration obviously has other fish to fry. They feel that you've got the fundamental responsibility. The industry obviously has the necessity to make money and to do all they can in making money to persuade the Members of Congress and the Board to be as lenient and permissive as possible and the trade associations too have that same view.

Now with that in mind, let me say that three very, very able experts in this area, Messrs. Levy, Sandler and Shackelford, testified before our committee yesterday and they told us this:

> FSLIC has always had the power to limit the activities of thrifts not meeting capital requirements. It can also replace management. It can issue cease and desist orders. In sum, it has had the substantial powers necessary to control and limit FSLIC problems even if it did not have the resources to clean them up.

Do you believe that the Home Loan Bank Board and FSLIC presently have the legal authority to stop FSLIC problems from getting worse even if they lack resources to clean up the problem? And if not, what additional legal authority should we give them now while we try to develop a cleanup plan?

FHLBB AND FSLIC HAVE LEGAL AUTHORITY TO STOP THE PROBLEM

Mr. **Janis**. I don't think you have to give them any legal authority now, Senator. They need money to close the insolvents. We have already discussed that. I think they have the legal authority now in terms of enforcement powers and I think they really have enough at this point. I don't think that has to be added to the list.

The **Chairman**. So they can limit the activities of thrifts not meeting their capital requirements right now. A Senate resolution obviously will try very hard to pass and maybe we can pass it and it would be very helpful I'm sure to encourage it, but they can do it.

Mr. **Janis**. Absolutely. And you put something in CEBA having to do with minimum capital requirements that has come out now in regulation form that allows them to raise the capital if they're involved in risky activities. That regulation relative to capital directives is in place. It comes from CEBA and they can use it if they need to.

The CHAIRMAN. What stands in the way—people have said, including Senator Hecht—and he's a former banking executive—he argues that much of this is a problem of mismanagement and I'm sure it is. What has kept you gentlemen from acting more aggressively in getting rid of poor management?

Mr. JANIS. The Department of Justice has been a big bone in our throats. I don't know how the other two past chairmen will react to this, but I think they will agree with me on this point. It's a gross oversimplification to say that fraud and mismanagement is the total problem as the Senator did yesterday. There have been new people that have come into the business. But the Justice Department has been a real thorn in our side, historically. White collar crime, in my day, was a very low priority. There was a failure to prosecute and there was a failure in the case of Empire of Mesquite, for instance. For years everybody knew Empire had done something wrong and it took 3 or 4 years for justice to get around to prosecute, so that everybody said, well, what Empire did must be OK, sure no one is going to come after them.

The CHAIRMAN. What does it mean when I say you can replace management and issue cease and desist orders? Can you do that? Replace management—if you have a savings and loan that is obviously being mismanaged and you say they have to get out and they need new management, can you put it in?

Mr. JANIS. In general, yes. A board of directors could fight a regulator on that, but I believe if you tell the board of directors what their personal liabilities might be in failing to remove the management, I think most boards of directors if you jawbone them, will certainly go along with the regulator. That is the first line of defense—removing management.

The CHAIRMAN. Let me ask each of you gentlemen, because I have great respect for all of you, how often did you move in to kick out incompetent management? Mr. Janis and then Mr. Pratt and Mr. Gray.

REMOVE INCOMPETENT MANAGEMENT

Mr. JANIS. That is a field function. That's not done by the FHLBB chairman. That's done by the PSA in the field, and I always supported my PSA's in this regard.

Mr. PRATT. I don't know, either. In other words, I join Mr. Janis. I know that these occurred. I don't know to what extent. We had very few institutions we absolutely closed them simply at different times.

The CHAIRMAN. I'm not talking about closing them. I'm talking about getting rid of the management and having new management come in.

Mr. PRATT. I don't know how many. The other point I would make is that I don't think that new good management is easily found. I think even the healthy portion of the industry is suffering a dearth of management qualified for the technological challenges today and then when you talk about putting someone in to a troubled situation where they may not have any upside but where you may need management better than you would need in a healthy institution, it may not be an easy task to find the right person.

The CHAIRMAN. I know it's very, very difficult, but I would appreciate it if for the record you could supply us with information as to how often that was recommended and how often it was carried out and whether or not the chairman should have more authority to make sure that the field acts more quickly and decisively.

Mr. GRAY. I would say the following. When we closed Empire Savings in 1984 it was a big problem for us. At that time we tried to look at what caused the failure and what kind of additional enforcement authorities we needed.

Your question, Mr. Chairman, whether the Bank Board has the necessary authority. The point is that if they get the authorities to move more quickly we can save money. That's always been our position and that's why I would still strongly urge that this committee go back and consider the recommendations that we have made for strengthening the enforcement authority of the Bank Board. We created a new and independent office of enforcement to try to expedite this situation to free their hands from some of the bureaucratic constraints, but I'll tell you until the day I left the lawyers at the Bank Board were telling me that they very definitely needed additional statutory authority to move along much more quickly to deal with this. I would beg the committee to look carefully at those things.

The CHAIRMAN. Well, that's exactly what I wanted to know. I've got to go vote. Before I do I want just a yes or no answer from each of you. Should the Government guarantee FSLIC notes? We had a strong recommendation yesterday from people in the industry that they should. Frankly I'm very concerned about doing that.

Mr. JANIS. For notes issued to the Federal Home Loan Bank System, absolutely yes. For notes issued to others, it has to be looked into.

Mr. PRATT. Absolutely yes. I think it's crazy to have a credit quality cloud hanging over the insuring agency. It makes no sense whatsoever. We're dealing with troubled credit. We're dealing with troubled institutions and then if the industrial companies or others that come to deal with FSLIC have to somehow determine the credit quality of the notes they get from FSLIC we're living in a very strange world.

Mr. GRAY. I think so is my answer.

The CHAIRMAN. Senator Garn.

Senator GARN. I just have one more question. To go back to this issue of the speed of closing institutions, once again, everybody agrees we ought to get rid of them as soon as we can. Mr. Janis, you particularly have talked about that. Assume that we've got enough money and money isn't the problem, then isn't it necessary just from a mechanical standpoint to have a lot more staff to handle it? I remember when Dick Pratt was staying up all night with what were massive closures at the time and I know the present chairman has lights in his office until 11-12 at night. So it's fine to say we ought to speed up, but beyond the issue of "is there enough money to go in," isn't it necessary to handle the situation physically even if it's just bailing out the depositors? This is something we fought with OMB about for years—with me trying to keep FSLIC and FDIC out of Gramm-Rudman-Hollings because it's not taxpayer's money and so that they can make decisions on how to use the money. But isn't there a mechanical and staff problem in doing what we all advocate—don't we need more?

Mr. JANIS. If we had all the money we needed now, you could liquidate, which doesn't take that much staff effort, and pay off the depositors or merge quickly if that could be accomplished. I would put the assets into an asset disposition corporation and dispose of them over time, don't dump them on the market, maximize the recovery of those assets for the benefit of the insurance fund and the Government. Clearly the cheapest way would be to do that kind of liquidation because of the excessive carrying costs of keeping them on.

Senator GARN. The reason I said money is because I can't quite agree with you that just paying up to $100,000 can be done that quickly and easily. As I've observed some of these things, you've got to go through a process that takes people and time to do. That was my question. The second part of my question is even if you had enough money, what is the cost to the fund over the long term of just going in and bailing them all out as quickly as you can versus trying to do it more methodically and save FSLIC money? Because obviously it's more costly than an assisted merger to just go in and pay off those depositors. So even if you had enough money, which is the most cost effective way to do it?

Mr. JANIS. Well, it used to be that liquidation was the most expensive, and trying to stretch out was cheaper. I think that may be changing now because of the risk factor of keeping the insolvents open. I think we've got to rethink that and consider liquidating more often—and we're bailing out depositors by the way, not stockholders, not bad management, not that kind of thing—we're bailing out depositors.

Senator GARN. Much as I'd like to hear your other answers and as much as I run 5 miles every day, I still have got to play O.J. Simpson to get to the floor. So the hearing will be adjourned.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

[Response to written questions and additional material supplied for the record follow:]

QUESTIONS FOR UNDER SECRETARY GOULD FROM SENATOR PROXMIRE AUGUST 2, 1988 HEARING

Question 1:

How much additional money can the thrift industry contribute to industry clean up?

Answer:

Currently, the only money, in addition to the regular premium of 1/12 of one percent of deposits, that the industry has contributed to the Federal Savings and Loan Insurance Corporation (FSLIC) is the 1/8 of one percent special assessment which began in 1985.

As I indicated during the hearing, continuing the special assessment for 10 years may be too long, but we believe the industry can handle this 1/8 of one percent special assessment for some additional time as determined by the Federal Home Loan Bank Board: that is, until the current program, which includes only a partial recapitalization of the FSLIC (that we requested in March 1986), some regulatory reform and charter enhancement, begun over a year ago, has been completed and had a chance to work. Congress will then have a better data base to evaluate the progress of the Bank Board's efforts.

Question 2:

For how many years should the special assessment be continued?

Answer:

At this time, it is unclear for how long the special assessment should be continued by the Federal Home Loan Bank Board (FHLBB). However, since the FHLBB evaluates the need for the assessment and the ability of the industry to pay it on a quarterly basis, the assessment will only be continued for as long as the FHLBB believes it is necessary.

Question 3:

Where should Congress obtain the funds that will be needed to resolve the savings and loan industry's problems?

Answer:

The FSLIC's projected cash flows show that it will have about $19 billion over the next three years to resolve the problems of troubled thrifts. The Bank Board has said that these resources are all it needs at this time, and that additional funds are currently not necessary. However, we understand that both the Bank Board and the General Accounting Office are revising their estimates and will report to Congress in the near future.

As I specified in my testimony and again in my answer to question seven, which follows, there are a number of ways Congress can help to reduce the FSLIC'S problems before providing additional money. In addition, in my opinion, before any more funds are made available the new Administration and Congress should evaluate the impact that the federal deposit insurance system has on the willingness of the managers and owners of financial institutions to take imprudent risks. Some structural reforms must be enacted to provide the proper incentives which will strengthen our financial system and protect depositors and taxpayers.

If additional funds are required, the FICO structure could be used at a relatively small annual cost to obtain sizeable amounts of resources, as I indicated in my testimony. The remaining Federal Home Loan Bank surplus could buy additional zero-coupon Treasury securities to repay the principal amount of additional FICO bonds. Some of the interest on these bonds could be paid by continuing the special assessment, while other sources to cover the interest payments would have to be examined and evaluated.

Question 4:

Do you believe that the savings and loan industry (often through its trade associations) has undue influence in the regulation of the industry? What do you think should be done to reduce the industry's control?

Answer:

If Congress believes the savings and loan industry has too much influence over its regulator, then it can hold hearings and ensure uniform treatment in all areas of capital, supervision, examination, and accounting. One way to lessen any perceived industry influence might be to insist that both bank and thrift regulators have the same regulatory requirements and standards for examination.

Question 5:

Should the savings and loan industry adopt the same capital standards as commercial banks?

Answer:

Yes, similar capital standards should be implemented as quickly as possible. As a general policy, Treasury supports making more uniform the regulation of thrifts and banks as their investment powers are made more uniform.

The Bank Board is reviewing its current capital rules in accordance with the Competitive Equality Banking Act's directive that the Bank Board impose capital requirements consistent with those of bank regulators. As of January 1, 1989, capital will be measured in terms of generally accepted accounting principles for public financial statements.

Question 6:

Do you believe that it is necessary to roll-back any of the powers that federally chartered savings and loans now possess?

Answer:

No, it is not necessary, if the institutions are adequately capitalized and supervised, since capital provides a first line of defense against FSLIC losses.

It may be useful, however, to review the advisability of requiring certain activities permissible for state-chartered institutions, but not for federally chartered ones, to be conducted in separately capitalized holding company affiliates as described in both my March 1986 and recent testimony to this Committee.

Question 7:

What, in your judgment, needs to be done to resolve the current crisis and prevent its recurrence?

Answer:

In March 1986, the Administration presented to Congress a three pronged strategy for resolving the current crisis in the thrift industry. The strategy consisted of: (1) strengthening capital requirements and halting the growth of insolvent institutions through improved examination and supervision; (2)

recapitalizing the Federal Savings and Loan Insurance Corporation (FSLIC) to speed the resolution of problem institutions; and (3) enhancing the franchise value of thrift institutions to attract outside capital to the industry and lower the FSLIC's resolution costs.

As you know, Congress delayed passing the full FSLIC recapitalization plan we requested two and a half years ago, added extraneous and controversial amendments, and then gave FSLIC only two thirds of what both Treasury and GAO thought was necessary to resolve the problem at that time.

The Federal Home Loan Bank Board (FHLBB) since then has strengthened its capital requirements; reissued a supervisory policy directive (SP-62) to limit the growth of insolvent thrifts; expanded the number and training of examiners; and accelerated the resolution of problem institutions.

In addition to our three pronged strategy and the actions of the FHLBB, we have suggested that Congress:

- authorize an additional $5 billion in borrowing by the Finance Corporation (FICO); this will bring the total FICO borrowing authority up to the amount recommended by the Administration two years ago;
- require state-chartered institutions that engage in activities beyond those allowed by federal regulations be placed in separately capitalized affiliates of a holding company, if the Bank Board decides such action is necessary;
- give the federal regulators the supervisory tools, such as temporary cease and desist orders, they have requested for years; and
- enhance the value of savings and loan charters for new buyers.

In summary, we believe that our three-pronged strategy continues to make sense. The challenge will be for Congress and the Administration to build or expand upon it in the future.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM GERALD J. LEVY, HERBERT M. SANDLER, and DONALD B. SHACKELFORD

September 16, 1988

Senator William Proxmire
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Senator Proxmire:

We would like to thank you for the opportunity to testify before your Committee on August 2. The plight of the FSLIC is a most urgent issue facing both our business and the country at large and we congratulate you on your timely hearings. We would like to particularly thank you for your part in getting the Senate to adopt a sense of the Congress resolution placing the full faith and credit of the United States behind the notes of the FSLIC.

We are pleased herewith to submit answers to the supplemental questions you have sent us to complete the hearing record:

How much additional money can the thrift industry contribute to industry cleanup? For how many years should the special assessment be continued?

Frankly, we do not believe that the industry should pay any more than is mandated under CEBA. By the end of this year, we will have already paid about $4.5 billion in additional insurance premiums. On top of that, CEBA has pledged up to $3 billion of retained earnings of the industry-owned Federal Home Loan Bank System to provide backing for FICO bonds. Thus, our institutions are already on the line for $7.5 billion to pay for the sins of competing institutions. We can find no other example of business in America being required to pay such sums to bail out failed competitors.

We would like to emphasize the extraordinary nature of what is happening. In the private enterprise system, inefficient firms fail and the efficient ones prosper. In our system, not only are the inefficient -- and sometimes even dishonest -- firms propped up, the honest, well-managed firms are subjected to a confiscatory tax in order to provide support to failed competitors that, on top of everything else, often engage in predatory pricing that makes it very difficult for sound companies to operate. And we are required to do this in spite of the fact that we have repeatedly warned the regulators of the dangers that these firms were posing to the system, often naming specific instances.

Beyond these very real equity considerations, we pointed out in our written statement (pp. 31 and 32-34) to the Committee the untenable nature of a continuation of the special assessment. We showed how it disadvantaged our institutions vis-a-vis our commercial bank competitors (where we are paying 2-1/2 times what the banks are for insurance and where the foreign-lending mistakes of the big banks are being shouldered by the taxpayer rather than by other banks), how it hinders us in building up our capital levels to the new required levels in the 1990s and how it depresses the stock prices of even healthy institutions thereby making investment to recapitalize failed institutions unattractive when healthy ones are available so cheaply. As far as the competitive burden of the special assessment is concerned, we would repeat the answer that Undersecretary Gould gave to your question at the August 2 hearing whether the Bank Board's contemplated ten-year continuation of the special assessment was reasonable and feasible. Mr. Gould, hardly a past champion of keeping the burden on healthy institutions to a minimum, said: "I consider that to be too heavy a burden." Many other observers outside of our business agree with the assertion of the impossibility of a long-term continuation of the special assessment.

In 1987, almost 10% of the unprofitable institutions in the business would have been profitable but for the special assessment. With overall industry profits weaker this year, this figure is likely to be worse in 1988. In short, between the special assessment and the so-called thrift premium on deposits -- due to the presence of so many insolvent institutions -- we are running the risk of creating a spiralling, ever-worsening problem unless a timely solution for the FSLIC's problems is found. Put another way, the failure to come up with a comprehensive solution for the FSLIC's problems that does not put an unsustainable burden on the industry is a recipe for adding new problems to the FSLIC caseload faster than current problems are being resolved.

Some may want to tap the Federal Home Loan Bank System for an even greater contribution than has already been pledged. Unfortunately, there is no more excess capital left there after the CEBA contribution is exacted. The remaining $12.3 billion (as of the end of July) of Bank System capital represents monies that our institutions paid directly into the System in return for shares of stock. If that is tapped, it will represent a direct charge to the capital of our business; in effect, it is no different from a further direct assessment on the industry.

Treasury Undersecretary Gould suggested at the hearing that one step the Congress should take is to amend CEBA to authorize the full $15 billion in bonding that the administration asked for last year. The Federal Home Loan Bank Board seems to think that such authority is unnecessary. With $3.75 billion already issued in FICO bonds, $10.7 billion issued in FSLIC notes and assistance agreements costed out at $8.4 billion, the indebtedness incurred on behalf of or by the FSLIC has already shot through the $15 billion level sought by the administration (and in excess of the CEBA-imposed limit). Thus, Undersecretary Gould's suggestion is a complete straw-man.

In the end, however, though we really do believe that it is neither equitable nor right for conservative institutions within the industry to have to continue to pay special assessments, the business might be able to live with some additional assessments on a guaranteed phased-down basis. We were terribly disappointed that less than one year after the passage of CEBA with its 5-year phaseout of the special assessment, Chairman Wall would come back to the Congress and indicate that the Board's projections had the special assessment running in full through 1998 at a staggering additional cost to the business of $18.3 billion. Frankly, it confirmed the industry's contention of last year that the administration was selling the Congress on a totally unrealistic program.

In sum, a guaranteed phased-down special assessment would provide an additional contribution from the busiess over and above what it has already paid. We assert that the business cannot afford to pay any more and we do not think it reasonable or fair that it be asked to.

Where should Congress obtain the funds that will be needed to resolve the S&L industry's problems?

Since there is a limit to the amount savings institutions can pay, a fact on which most observers agree, and since even Chairman Seidman admits that the FDIC has its hands full in dealing with problems in the commercial banking system, the unpalatable fact emerges that only the U.S. Treasury has the resources to deal with the problem.

In fact, a recent American Banker article (attached) by Stan Silverberg, the former director of research and strategic planning with the FDIC, argues that the Treasury has in a real sense already spent the money:

> "the Treasury is already on the line to pay the cost, even though, technically, the obligation is not currently acknowledged as Treasury debt. The expectation that the Treasury will eventually have to pay is very likely already built into prevailing Treasury yields. ... If the Treasury were a private corporation, accountants probably would have required the Treasury to book the indebtedness."

Mr. Silverberg goes on to point out:

> "The only unambiguous result of the Treasury outlay will be a rise in the government's debt. But the interest payments on this additional Treasury debt will be substantially less than the growth rate of the Treasury's obligation in connection with the FSLIC. Paying the bill sooner will ultimately result in less cost and less government debt."

Besides allowing losses to grow by not facing up to the problem, we are also wasting real resources to preserve the accounting facade by setting up the FICO so the money it borrows can be counted as inflows for government accounting purposes. For this dubious luxury, we are needlessly paying about 100 basis points extra (above the comparable rate for Treasury securities) for the money the FICO borrows.

In sum, because the policing necessary for insured institutions in a deregulated environment was not there, a problem has been allowed to grow to such enormous proportions that only the federal government has the resources to fix it.

It may be possible to set up some sort of mechanism to borrow the money in the capital markets and pay it off over time so that there is not an enormous hit to the federal budget in any one year. If this is done, however, care should be taken so that real resources are not needlessly wasted such as is the case with the FICO paying above Treasury yields.

On the other hand, a new president might prefer to take the full hit in his first year in office. In that way, although the deficit would be increased immediately, it would show a significant downward trend thereafter.

Do you believe that the S&L industry (often through its trade associations) has undue influence in the regulation of the industry? What do you think should be done to reduce the industry's control?

Many in the industry would admit that some actions -- advocated by the industry itself, although not unanimously -- were taken by the regulators in the early 1980s that, in hindsight, allowed subsequent problems to become worse than they would otherwise have been. Chief among them, we would place the weakening of net worth requirements. These were adopted, however, to give breathing space to institutions that were crippled by the confluence of deregulation of liabilities and sky-rocketing interest rates. Also they enabled the Bank Board of the time to avoid having to report enormous number of savings institutions being in difficulty.

What was not appreciated by the business -- or anyone else -- at the time, however, was that the Bank Board would not be given the police force necessary to enforce safety and soundness standards in a deregulated environment and that unscrupulous people would be allowed to enter the business that should never have been afforded the opportunity to gain control of insured institutions.

Since then we think the business has unfortunately not had enough influence on the regulator. Once we became aware of the developing problems, we demanded that a stop be put to the abuses. The three of us have served on a U.S. League Task Force on the FSLIC for the last three years and, since as early as 1985, we have had meetings with the regulators, the Bank Board and the president of the Federal Home Loan Bank of Dallas, demanding -- to no avail, we might add -- that they put a stop to rapid growth and other abusive practices by institutions that had little or no real capital at stake.

In March 1986, the Task Force issued a report that had numerous specific recommendations to improve supervision by the Federal Home Loan Bank Board. A sampling of those recommendations include:

** "The Federal Home Loan Bank System's supervisory and examination staff should adopt an "instant response" mode of operations."

** "The Federal Home Loan Bank Board should create a National Special Strike Force (NSSF), which would be composed of highly qualified Bank Board supervisory agents, examiners, accountants and attorneys and would be empowered to hire outside financial, legal, accounting and other experts as necessary. The NSSF would respond immediately to supervisory problems that pose a critical and imminent danger to the FSLIC. The strike force could operate without limitation across individual Bank district lines."

** "The Federal Home Loan Bank Board should audit the examination and supervisory efforts of the Federal Home Loan Bank System to make sure that the urgent problems are being addressed."

** "The Federal Home Loan Bank Board should act immediately to improve tis monitoring and problem-flagging system so that problem cases can be targeted for swift response."

** "The Task Force recommends altering the loan-to-one-borrower regulation to prevent institutions from investing 100% of their capital in a single loan. Specifically, the Task Force recommends that the regulation be changed so that an institution could lend no more than 25% of its net worth to one borrower."

** "The Task Force supports amendments to the Change in Savings and Loan Control Act that would enable the Bank Board to be more effective in its efforts to ensure that reckless or unscrupulous individuals or groups do not acquire control of savings institutions."

** "The Task Force supports the elimination of most noncash contributions to net worth."

Contrary to the opinion implied in your question, we think it is an extraordinary situtation where a regulated industry is demanding that the regulator tighten up its regulation and supervision.

We remain concerned that all is still not being done that could be done. As you know, we and probably a majority of our peers remain very troubled by rapid growth and other signs of risk-taking by weak or insolvent institutions.

Up until Chairman Gray stood up to the OMB and OPM and increased the examination and supervisory personnel by transferring them to the Bank System, the biggest problem may have been the lack of a sufficient number of people in that area. The increased number, professionalism and remuneration levels of the examination and supervisory people will help avoid some of the problems and abuses we had in the past.

But a major problem remains -- the number of insolvent institutions that the Board has to handle. Without adequate resources in the FSLIC to find a permanent resolution to these cases, the Board is in a kind of conflict-of-interest situation. With the insolvent institutions remaining in operation, there is sometimes a temptation on the part of the Board to allow those institutions to take excessive risks in the hope that those risks pay off and the institution can get itself off the FSLIC's caseload.

Maybe even more serious, the Board is approving what have come to be called "thin deals" -- by the way, the same is happening with the FDIC. Insolvent cases are "solved" by giving them to other weak institutions or to outside investors that bring little or no capital to the table. The incentive for such acquirors is, with little of their own capital at stake, to take enormous risks in the hopes of enormous payoffs. If the risky activities fail, little private capital will be lost but the FSLIC will re-inherit an even greater mess.

The other problem the Board faces with the number of insolvent institutions it has on its hands is that dealing with these cases is enormously time-consuming. This deters the Board from devoting the attention it should to the surviving portion of the industry, making sure that fresh problems do not arise in that population. Also it is difficult to enforce rules, such as increased minimum capital requirements, on the surviving institutions when there are so many weak or insolvent institutions operating that are patently not in conformity with the regulations and paying above-market rates for deposits.

These are all implicit costs, that are not widely recognized, of delaying a comprehensive and sufficiently funded solution of the FSLIC's current problems. We do not believe that undue industry influence on the regulators is now a problem. We are all sufficiently sobered by what has happened so that, in fact, we will be supportive of -- demanding of -- prudential regulation and will gladly pay for a sufficient supervisory force to do all that is possible to ensure that we do not again face the sort of problems that we have seen in the past few years. We have paid enough for the malefactors, not only in explicit increased premium and deposit costs, but, moreover, the actions of these people have besmirched the reputation of all who have dedicated their lives to this business.

Should the S&L industry adopt the same capital standards as commercial banks?

Both banks and savings institutions, in different ways, are moving to risk-based capital standards. We -- and most of our peers -- would strongly support the proposition that institutions, be they banks or savings institutions, with the same risk profile should be required to maintain the same level of capital. High-risk banks or high-risk savings institutions should meet a high, tough capital standard. Low risk institutions of either type could be required to have a somewhat lower standard -- although there should probably a certain minimum that every institution should be required to meet. We do not necessarily know what the minimum is but 6% seems to be a fairly widely accepted number.

When we endorse the same risk-based capital standard regime for banks and savings institutions, we are not thereby endorsing the standard recently adopted by the Federal Reserve and being considered by the FDIC and the Comptroller. In fact, we regard that new measure as a serious weakening of bank capital standards. For example, it can be shown that the banks' new standard could allow a bank to invest in huge amounts of long-term fixed-rate mortgage-backed securities, with all their inherent interest rate risk, and be required to provide almost no capital support.

The banks' new standard is being phased in over several years. Our system is also phasing in tougher capital standards over more or less the same period. After the phase-in, our institutions will have considerably tougher risk-based standards than the banks. Thus, although we support the concept of similar capital requirements, we believe it should be along the lines of our tough standards rather than the banks' watered-down ones.

Do you believe that it is necessary to roll back any of the powers that federally chartered S&Ls now possess?

Some of the measures that we and many of our colleagues have felt for years to be necessary have still not been instituted. The following may not be an exhaustive, all-inclusive list but, we believe, they would do much to help curb abuses in the future:

A. Real capital requirements and growth limitations must be enforced.

B. The current 40% of assets limit on commercial real estate lending should be reduced to 20%.

C. Today's loans-to-one borrower limit which equals 100% of equity should be tightened to be in line with the statutory standards applied to commercial banks.

D. The ability of thrifts to invest in junk bonds should be limited.

E. No one individual should be allowed to charter a new thrift institution. (In the early 1980s, the minimum number of shareholders in a FSLIC-insured institution was reduced from 400 to one. If there are a significant number of shareholders, it is more difficult for one or a small group to use the institution as a piggybank to finance their own projects.)

F. Loan-to-value ratios should be reduced from the current 100% level.

G. Noncash contributions to net worth should be eliminated.

H. Some limitations on brokered deposits should be put in place.

What, in your judgment, needs to be done to resolve the current crisis and prevent its recurrence?

Much of the material in answer to your other questions addresses this final one also. We would summarize with a few crucial points:

1. Sufficient resources should be provided to the FSLIC to resolve on a permanent basis the current caseload of insolvent institutions. Quick-fix resolutions, such as "thin deals", should be avoided. In this regard, it is vital that the full extent of the losses facing the FSLIC should be openly and honestly admitted as well as a recognition of the fact that, as Stan Silverberg noted in the American Banker article, these losses have already been incurred.

2. It should be recognized that deregulation does not mean no regulation. Institutions cannot be allowed to do anything they want using federally-backed deposits. Examination, supervision and enforcement tools should be used to their fullest extent. Monitoring systems should be put in place that allows supervisory attention to be paid immediately to institutions that exhibit increases in risky behavior. Individuals that breach their fiduciary responsibility should be dealt with rigorously, including criminal prosecution where warranted. We are hopeful that the beefing up of our system of examination and supervision over the past several years is a good start in this regard in dealing with the deregulated environmnet.

3. Private capital at risk is the best antidote to reckless behavior. Any institution that wants to engage in risky activities should be required to have capital commensurate with the risk. Institutions with little or no capital, measured on a tangible GAAP basis, should be tightly constrained in the activities in which they can engage. In measuring exposure, off-balance sheet risks should be included. Also, means of measuring interest rate risk should be improved and steps to reduce that risk should be rigorously enforced.

We hope we have been responsive to your questions. We stand ready, of course, to respond to any other questions you might have. We again want to thank you for the opportunity to present our views on these urgent matters.

Sincerely

Gerald J. Levy

Herbert M. Sandler

Donald B. Shackelford

American Banker
8 - 31 - 1988

COMMENTARY

Treasury 'Accounting' Could Resolve FSLIC Problem

By STAN SILVERBERG

> 'Getting additional funds from solvent S&Ls will be extremely difficult and probably self-defeating since it would risk pushing more institutions into insolvency.'
>
> — Stan Silverberg

MOST analysts who are familiar with saving and loan associations are convinced that the cost of closing or merging insolvent S&Ls is way beyond the resources that will be available to the Federal Savings and Loan Insurance Corp., assuming no new revenue sources.

Cost estimates keep rising as reported S&L losses and the net worth deficiency of insolvent S&Ls increase. The latter have reported losses of about $18 billion during the five quarters that ended March 31, 1988.

If insolvent S&Ls could be closed or merged in the next year or two, the cost, under the most favorable circumstances would be at least $50 billion and informed analysts recently placed estimates in the $60 billion to $75 billion range. The passage of time will increase the cost of disposing of insolvent S&Ls.

The FSLIC has attempted to conserve its available cash by offering its IOUs (FSLIC notes) to institutions acquiring insolvent S&Ls and by entering into long-term assistance agreements with little cash up front. Those who have accepted FSLIC notes presumably assume that the FSLIC will be bailed out or that the Treasury or the FSLIC's successor will honor the notes.

The FSLIC has also tried to reduce costs by entering into "thin deals" whereby other S&Ls or investors acquire insolvent institutions. Some of these transactions are with marginal S&Ls that might not otherwise survive.

They are willing to take a limited amount of assistance as long as it counts for regulatory capital and assures their survival for several years. In some transactions, forebearances on capital requirements and growth restraints allow institutions or investors to operate with enormous leverage so that the potential for large gains outweigh the risk of loss on a small capital base (most of the risk is assumed by the FSLIC).

Possibility of Future Problems

These arrangements increase the probability that the deal will come back as a future problem with future costs. They also impose a burden on competing institutions that have to meet regulatory standards and promise to make life more difficult for whomever supervises S&Ls in the future.

The FSLIC can also delay dealing with insolvent S&Ls. However, delay is very expensive.

The real (as opposed to reported) net worth deficiency in insolvent S&Ls has to be financed, and the cost of funds and operating expenses in these institutions is very high. Together, they probably amount to at least 11% of liabilities so that financing a $60 billion "hole" costs more than $6 billion annually.

In addition, there is apt to be further asset deterioration resulting from inappropriate incentives for managers of insolvent institutions, problems related to attracting or maintaining quality management, and a deteriorating franchise. While these factors cannot be easily quantified, there is good reason to believe that they will raise future costs considerably.

Keeping insolvent institutions alive keeps the cost of funds high for solvent S&Ls and exposes them to other competition that further reduces margins.

In addition, it makes it difficult for the Federal Home Loan Bank System to pursue the tough, even-handed supervisory policy that is needed and to implement necessary changes in the insurance-supervisory system. Thus, there is a very strong case for closing or merging insolvent S&Ls as quickly as possible.

Money Appears to be the Problem

The problem appears to be money. The FSLIC is substantially insolvent. S&Ls are already paying an extremely high assessment premium on their deposits.

Getting additional funds from solvent S&Ls will be extremely difficult and probably self-defeating since it would risk pushing more institutions into insolvency. If Congress chooses to tap some or even all of the Federal Deposit Insurance Corp.'s net worth, that would not provide sufficient resources since most of the FSLIC's "hole"

Mr. Silverberg, formerly director of research and strategic planning at the FDIC, is now special consultant to Golembe Associates.

would remain.

A large share of the cost of resolving the S&L problem will necessarily have to come from general Treasury funds, and if the problem is to be resolved quickly, most of the funding will have to come from the Treasury (Congress could elect to recapture some of this outlay through future insurance assessments).

A case can be made that government policy — which contributed to wide swings in interest rates, opposed variable rate mortgages, and permitted lax supervision of S&Ls — is far more responsible for today's savings and loan problems than the solvent component of the S&L industry.

A Treasury "outlay" of, say, $50 billion over the next few years might be hard for Congress to swallow. However, as suggested, delay will raise the present value cost in addition to imposing indirect costs on the system.

While we would not want to minimize the importance of what would appear to be so large a budget outlay, it is easy to exaggerate its financial and economic significance. The FSLIC is substantially insolvent. The Competitive Equality in Banking Act of 1987 specifically placed the Treasury behind the FSLIC as a guarantor of FSLIC-insured deposits.

Thus, the Treasury is already on the line to pay the cost, even though, technically, the obligation is not currently acknowledged as Treasury debt. The expectation that the Treasury will eventually have to pay is very likely aleady built into prevailing Treasury ields. When the funds are obligated nd "spent," Treasury debt will ncrease.

If the Treasury were a private corpoation, accountants probably would have required the Treasury to book the indebtedness. At a minimum, analysts would have paid considerable attention to the footnote.

Were it not for existing accounting convention that does not count Financial Corp. borrowing and FSLIC notes as part of the federal debt, about $10 billion of the Treasury cost would have already been "incurred."

It is important to appreciate that, from an economic standpoint, the cost of the S&L and the FSLIC problem (up to today's exposure) has already been incurred.

Projects that were not economically viable have already been built or partially built. Interest payments in excess of income have already been made, private planes have already been bought and flown, etc.

When the Treasury pays the bill there will be no significant purchase or bidding for economic resources. The money will facilitate closing and merging insolvent S&Ls. While some jobs will be lost and some new ones created, the magnitude of these economic effects will be in the millions of dollars — not in billions.

Current depositors or other creditors will be no richer or no more liquid through the process. Depositors know their claims are good whether the Treasury chooses to back them now or in the future.

Some churning will occur in financial markets. Some high cost deposits will disappear and some portfolios will be adjusted to take additional Treasury obligations. However, it is not even obvious whether the net financial market impact of all this ought to be higher or lower interest rates (clearly it will result in lower deposit costs vis-a-vis Treasury yields).

Unless taxes or expenditures are otherwise affected, there would be no basic change in the demand for real resources (apart from a net reduction in jobs and excess facilities associated with closing or merging failing S&Ls). If Congress sought to raise tax receipts or lower expenditures to "offset" the cost, the impact of this clearly would be deflationary. Congress is not likely to do this.

The only unambiguous result of the Treasury outlay will be a rise in the government's debt. But the interest payments on this additional Treasury debt will be substantially less than the growth rate of the Treasury's obligation in connection with the FSLIC. Thus, paying the bill sooner will ultimately result in less cost and less government debt.

To reiterate, most of the costs of current S&L insolvencies have already been incurred. The process by which the Treasury pays largely involves accounting.

No real resources will be purchased by the Treasury and no significant transfer payments will be made. This is not to say that there won't be substantial financial and real benefits from resolving the S&L problem.

It is important that Congress appreciate that the "budgetary outlay" to pay the cost would not be like other outlays. Resources won't be drawn away from defense or education. Transfers won't be made to dishonest or incompetent S&L executives. We are basically talking about some accounting adjustments, and they should be treated as such. ■

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
JAY JANIS

Q.1. In his testimony Mr. Pratt suggested that the Federal Home Loan Bank Board needs a better system of accounting and information. What specific improvements do you recommend in this area?

Answer 1. With regard to accounting information, I suggest the Committee carefully consider Mr. Pratt's suggestions, since it was during his chairmanship that the Bank Board significantly began to deviate from GAAP.

a. My specific suggestions have to do with the fact there should be no substantial deviation from GAAP generally. The purpose of accounting is to inform the public accurately as to the financial condition of companies. Since GAAP is the accepted standard, it follows that banks and thrifts should generally follow GAAP in reporting to the public.

b. In order to maintain a level playing field, I would suggest that the Basle Accords, which will be used for commercial banks, also be adopted for use by thrifts in terms of capital requirements. Obviously, the Federal Reserve, in adopting the Basle Accords, will provide protection in the form of additional capital for the interest-rate risk that could be inherent in holding a portfolio of unhedged fixed-rate mortgages or mortgage-backed securities.

c. Another consideration is that loan losses should be equally treated by bank and thrift regulators. In particular, loans to developing countries (LDCs) and real estate loan loss provisions both should be enforced in an equally tough manner.

Q.2. Where do you believe Congress should obtain the funds that will be needed to resolve the S&L industry's problems?

Answer 2. The funds to resolve the thrift crisis should come from public monies. For instance, this could include the interest on sterile reserves held by the Federal Reserve Board. In any event, the funds used should be leveraged and stretched out in a manner to avoid Gramm-Rudman sequestration. See, for example, a plan put forth very recently by Congressman Gonzales of Texas involving a Treasury loan at below market interest rates by which FSLIC would use a new credit line to issue zero coupon notes which, in turn, would be exchanged for repossessed and delinquent assets of savings institutions on the basis of their full estimated liquidation value. These would be bundled into securities and sold on the open market. This and other similar proposals should be studied carefully.

Q.3. a. During your tenure at the Bank Board, how often was it recommended that incompetent or dishonest managers be removed from from their association?

b. How often were these removal recommendations carried out?

Answer 3. Please see the attached chart which I obtained from the FHLBB. Column two is responsive to your inquiry. I have their permission for the release of this information.

Q.4. The industry witnesses at the August 2, 1988 hearing criticised the FHLBank System's lack of action to stop the abuses that have been occuring in the S&L industry. In your opinion, how effective is the system of supervision and regulation today? What problems do you see occurring? What changes do you recommend? Do you think that the Bank Board should have taken the oversight of Lincoln Savings away from the FHLBank of San Francisco?

Answer 4. There has been a vast improvement in the supervision and examination system for thrifts in the last year or two--improvements which taken as a whole have been nothing short of dramatic. One problem that remains is the chartering of de novo thrifts by the states, and in this connection, the Feds should have the authority to prevent abuses by the states in this area. With regard to the switch of oversight of Lincoln Savings away from the Federal Home Loan Bank of San Francisco, it is difficult to make judgements when one is no longer in the system; however, as a general rule, I oppose the switching of oversight from one district to another unless the district in question lacks the competency to handle a specific, complex matter. In the case of Lincoln Savings, I doubt very much that San Francisco lacked the competence to handle Lincoln, since their supervisory staff is one of the most sophisticated anywhere in the system.

Q.5. Does the Federal Home Loan Bank Board Chairman need more authority to ensure that principal supervisory agents act promptly and decisively to deal with S&L problems?

Answer 5. The Federal Home Loan Bank chairman does not need additional authority to ensure that supervisory agents act promptly and decisively. That authority already exists. No changes are needed in this area.

Q.6. Do you believe that the S&L industry (often through its trade associations) has undue influence in the regulation of the industry? What do you think should be done to reduce the industry's control?

Answer 6. I totally disagree with the contention that the S & L industry and its trade associations have exerted undue influence in the regulation of the industry. This is a favorite whipping boy of the press, and it is absolutely not true. There is no question that the trade associations attempt to influence the regulation of the industry, but the simple fact is that the Federal Home Loan Bank Board, in particular, its Chairman, has enormous power. The Bank Board's responsibility is to Congress, since this is an independent agency of government. The Chairman must look only to Congress and to his own conscience in terms of doing what is right. There is no excuse for blaming his failure to act on the industry or the trade association. He is the regulator and he has the power. The issue of "undue influence" is a canard which should no longer be perpetuated.

Q.7. Should the S&L industry adopt the same capital standards as commercial banks?

Answer 7. The savings and loan industry should adopt the same capital standards as commercial banks--in particular, the Basle Accords--assuming that the Federal Reserve provides for protection of the insurance fund from interest rate risk that might be built into portfolios of fixed-rate mortgages and mortgage-backed securities which are unhedged.

Q.8. Should the Bank Board should participate regularly in the activities of the Federal Financial Institutions Examination Council?

Answer 8. The Bank Board should participate regularly in FFIEC activities. This is a useful group, and although some of the functions and actions of the group are only tangential to the S&L business, many of its pronouncements are relevant.

Q.9. Do you believe that it is necessary to roll-back any of the powers that federally chartered S&Ls now possess?

Answer 9. Yes. Certain federal savings and loan powers should be rolled back. For instance, the 40% commercial real estate authority; the 100% loan-to-value ratio lending; and 100% loans-to-one-borrower. These are too liberal.

ENFORCEMENT ACTIONS OF THE FEDERAL HOME LOAN BANK BOARD

Calendar Year	C&D Orders	No. of Individuals Removed and/or Prohibited	Supervisory Agreements	Consent Merger Resolutions & Agreements	No. of Investigations Completed by Office of Enforcement	
					Formal	Informal
1980	3	1	1	6	6	10
1981	8	2	0	33	8	6
1982	13	6	5	49	10	10
1983	17	21	39	22	17	15
1984	13	22	116	38	24	20
1985	28	22	233	65	30	30
1986	58	48	214	130	30	25
1987	25	44	106	102		

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FRO
JAY JANIS

Q.1. If you were the current Chairman of the FHLBB what specific steps would you be taking now to address the problems of FSLIC and the FHLBB?

Answer 1. If I were chairman of the Bank Board at this time, I would do the following:

1. I would accurately state the true costs of dealing with the FSLIC problem. It is greater than what has been reported to date.

2. I would actively be working on devising alternative funding mechanisms to deal with the FSLIC problem--providing pros and cons and cost benefit analysis for each of various plans that are devised. The key to any plan is its ability to leverage funds and stretch out the costs to avoid impact on the federal budget.

3. I would propose legislation for an asset-holding company for consideration by Congress. It is obviously needed.

4. I would require FSLIC to resolve cases faster. In particular, I would refocus FSLIC on closing (i.e., liquidating) some 300 GAAP insolvent institutions for the

relatively small sum of $2 billion (which is the amount of negative net worth in these 300 insolvent institutions). This would be the best use of a relatively small amount of money, since it would reduce the risk of GAAP insolvent institutions which remain in business to take significant risk as a means of correcting their situation.

Q.2. In retrospect, what would you have done differently during your Chairmanship? Please be specific.

Answer 2. There are several things that I would have done differently during my chairmanship if I could turn back the clock:

1. I would have told Congress that it was wrong to have deregulated deposits as quickly as contemplated. The DIDC, in fact, moved much faster than Congress had anticipated, completing deposit deretulation in four, rather than six, years. Even the six-year Congressionally-mandated timetable was too rapid.

2. I would have pushed through a true ARM. The rollover mortgage that my Board adopted in 1980 was not flexible enough for wide use by thrifts to restructure their portfolios. I should have fought with consumer groups,

faced up to the opposition from the real estate lobby, and overridden whatever Congressional objections there might have been.

3. I should have convened a group of the leading experts in the field to chart the path of deregulation on a step-by-step basis out into the future.

4. I should have anticipated the crisis that began to occur in 1983 and '84 with regard to asset investments and new savings and loans which were using newly granted state powers and beefed up examinations and supervision accordingly.

Q.3. What are the implications of assessing healthy institutions to pay for losses?

A) Equity
B) Affordability
C) Competitive interaction with banks and other financial institutions

Answer 3. There are serious implications in assessing institutions to pay for the losses, beyond what has been enacted in CEBA.

a. It is unfair and possibly illegal to wipe out stockholder equity. Healthy S&Ls are the victims, not the perpetrators, of the problem.

b. It is not possible for healthy institutions to pay more than they are now paying. At the present time, the general and special assessments represent approximately 40% of the pre-tax profit of the business. This is based on the calculation that the healthy institutions, on the average, are earning approximately 50 basis points return on assets (ROA). The special and regular assessments amount to approximately 21 basis points ROA. Continuing this heavy assessment burden condemns the institutions to second- class citizenship and will eventually bring about their failure--at much greater cost to the government ultimately.

c. The continued assessment at the present high levels places an unfair competitive burden on thrifts relative to banks and other institutions, and thus, in the long run, adversely effects the thrifts' ability to finance housing on a reasonable basis in terms of the borrower.

Q.4. How is it that this problem could reach such crisis proportions?

Answer 4. The thrift problem reached crisis proportions because no one realized the depth of the economic problems in twelve or fourteen states across the nation. Most observers thought of the FSLIC problem in these states as if it was typical of the 1950s, '60s, and '70s--that is, that these areas were in the midst of a real estate recession as a result of adverse real estate cycles. In fact, the conditions in these twelve or fourteen states in the 1980s more closely resembles the era of the 1930s Depression. In Texas, for instance, the losses in the city of Houston will be approximately 2 1/2 times the losses of the Depression. Specifically, the losses anticipated on single-family homes in that area will approximate 30% of loans made, whereas in the 1930s, it was between 12% to 14% loss ratios that were experienced nationwide. No one has focused on the real depth of the problem in these states. Of course, it is not just the savings and loans located in those dozen or so states, but all of the lending by savings and loans across the nation that took place within those states that is crucial. The severity of the problem in those states simply was misjudged by everyone. Instead of being able to recover 70 or 85 cents on the dollar--as was the case in the 1950-1970s--the recovery rate on bad loans, in particular single-family houses, currently is much less. Simply put, there is a qualitative difference between a real estate depression and a real estate recession. It is not just a quantitative difference. There are structural problems in a depression that cause a downward spiraling of values that is unique and special to a real estate depression. This is a phenomenon that is not well understood but is nonetheless the proper explanation for our collective underestimation of the severity of the problem.

Q.5. Why is it that the FDIC appears to be in better shape than the FSLIC?

Answer 5. The FDIC seems to be in better shape than the FSLIC because the FDIC has not faced up to its loan loss provisions with regard to loans to developing countries. Moreover, the FDIC has a much better public relations program, in part because a very credible accountant is in charge of that agency, and he has managed to convince Congress and the public that the problems are being handled by his agency. In part, this is true. FDIC-insured institutions have not suffered from the real estate depression in the economicly-impacted states as much as S&Ls; moreover FDIC did not have the poor supervision that was evident in the FHLBB system prior to 1987-88. Nonetheless, the differences between the two funds are not nearly as great as they appear to be.

Q.6. Should there be a separate thrift industry?

Answer 6. A separate thrift industry is vital to this nation. This is because borrowers cannot compete for the flow of available credit against other large, well-capitalized U.S. corporations and other borrowers. Other nations around the world have realized this problem, and a variety of separate mortgage finance systems have developed in almost all of the industrialized nations of the world. For the United States to eliminate its separate system would be disasterous--not only in terms of adequately housing our citizens but also in terms of preserving our democracy. In fact, if we did eliminate our separate mortgage finance system, it would not be long before we would have to create a new one--just like the other nations in the world have created one.

Q.7. Should FSLIC/FDIC be merged, and if so, should a separate FLHB system be maintained?

Answer 7. It would not do any good to merge the insurance funds at this time. The economic benefits simply would not be there, but a single fund at some future date might make sense if it is part of a larger "fix" to the FSLIC problem. In any event, a separate Federal Home Loan Bank system should be maintained as a source of long-term credit for housing finance. The Federal Reserve system would be a poor substitute for the FHLB system.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM JAY JANIS

I have a very broad question about FSLIC generally. Please assume for the moment that FSLIC clearly had enough money to handle the resolution of all the problem thrifts -- that funding and the source of funding were not at issue. What would be the most cost-effective way to handle the resolutions? That is, what would be the least expensive way for FSLIC to spend the money, taking into account the problems of keeping some thrifts alive temporarily? Should FSLIC simply liquidate all the thrifts as fast as possible, paying off only insured depositors? Aren't such depositor payouts typically much, much more expensive than arranging so-called "purchase and assumption of assets" transactions? If so, isn't there a trade-off between getting the problem behind FSLIC quickly and spending too much money up front to do so? Furthermore, would FSLIC need a great deal more administrative resources than is feasible if it tried to liquidate insolvent institutions all at once? Or do you believe that the cost of delay would outweigh the increased up-front cost of liquidation? Or that there are just too few potential acquirers to make "P & A's" feasible? In short, is it better to spend a great deal of money up front or stretch some of it out over a longer period of time?

Answer to Question from Senator Garn by Jay Janis

August 3, 1988 Hearings

In normal times, the most expensive way of dealing with FSLIC case resolution is the liquidation method. (This may not always be the case, depending upon the franchise value of the insolvent institution in question as well as the type of assets in its portfolio). Nonetheless, these are not normal times. In these times, I would use liquidation more liberally because of the great danger to the government in keeping insolvent institutions open. At the present, we are spending somewhere between $7 and $10 billion per year as a "carrying cost" to keep insolvent institutions open. More important, the government is running the risk that insolvent institutions that are allowed to remain open are apt to take on greater risk as a means of attempting to recover. This subjects the insurance fund to significantly greater dangers; therefore, the so-called short-term, high-cost of liquidation outweighs the longer-term costs of not closing institutions. What is needed is a change of emphasis to a greater use of liquidation--but not total reliance on this method. As I said in my testimony, there are approximately 300 institutions that are GAAP insolvent which have a negative net worth of little more than $2 billion. Thus, for that relatively small amount, 300 institutions could be closed. I would use that $2 billion for the purpose of closing those institution. I would use "purchase and assumption" techniques for some of the tougher cases. Thus, I disagree with the premise in Senator Garn's question that it would cost a great deal of money up front to liquidate institutions, since I believe some 300 of them could be liquidated for a relatively small amount.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

August 23, 1988

Honorable William Proxmire
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

Former Federal Home Loan Bank Board (FHLBB) Chairman Ed Gray and certain thrift industry representatives recently appeared before your committee. Their testimony included erroneous statements and I would like to take this opportunity to correct the record.

(1) Mr. Gray and the industry representatives stated that the Office of Management and Budget (OMB) impaired FHLBB supervision of the thrift industry by opposing staff increases in 1983-1985.

As you know, FHLBB is subject to two types of spending and staffing limits, one imposed by Congress and one imposed by OMB. However, neither operated as a constraint on FHLBB's ability to hire up over the past several years.

First, OMB does not determine staffing levels; it merely sets staffing ceilings. When an agency is fully staffed, it operates at its ceiling. Only then may the staffing ceiling act as a constraint on hiring. In the case of the FHLBB/FSLIC, actual staffing levels during the last several years consistently have been well below the ceilings approved in the President's Budgets, as the enclosed table shows. For the years 1983-1985, FHLBB requested ceilings that far exceeded its actual staffing levels. Since FHLBB's internal staffing problems left it unable to hire up to an existing ceiling, there was never any need to increase the ceiling. Actual FHLBB/FSLIC staffing levels (measured on a full-time equivalent basis) fell below authorized ceilings by 23 staff years in FY 1983, 68 staff years in FY 1984, and 159 staff years in 1985.

Since 1985, when OMB approved every requested ceiling increase, notwithstanding the FHLBB's failure to hold or attract adequate staff to reach its authorized ceilings, the FHLBB still has failed to reach its authorized staffing ceilings. It was 129 staff years under ceiling in 1986 and 97 staff years under ceiling in 1987.

Second, through 1985, the FHLBB's ability to hire additional examiners was capped by the annual limit Congress enacted on FHLBB thrift supervision and examination spending. In each of the years in question (1983-1985), Congress agreed to the Administration's proposed maximum spending limit for thrift examination and supervision. Had the FHLBB been able to meet or exceed the approved staff ceilings, then OMB could have considered both a ceiling increase and a request to increase the enacted expense limitation. This, however, never occurred.

It should also be noted that the FHLBB felt constrained by federal civil service pay and other restrictions. Mr. Gray cited Office of Personnel Management (OPM) restrictions as the justification for delegating FHLBB examination staff in July 1985 to the Home Loan Banks, which are not subject to OPM restrictions. However, Mr. Gray made no effort to seek assistance from either OMB or OPM to address the FHLBB's staffing problems before delegating the examination staff. Nor did he take up my offer of assistance to seek resolution of the personnel problems with OPM before delegating additional supervisory staff to the Banks in September 1986.

(2) Mr. Gray stated that, in the Spring of 1987, he had requested 1,000 additional FSLIC staff years for 1988, but that OMB had cut the request down to 400.

This is simply not accurate. In the Spring of 1987, Mr. Gray advised me that he expected the recapitalization program to require additional staff for FSLIC. I assured him we would support whatever he felt his staffing needs were. FHLBB staff subsequently informed my staff informally that the FHLBB planned to request a staff increase in the range of 600 to 1,000 staff years. However, the formal submission from FHLBB requested an increase of only 100 staff years in FY 1987 and 400 staff years in FY 1988. I personally saw to it that the request was approved in full, as promised.

It should again be noted that FHLBB/FSLIC has yet to fill the positions, and expects to utilize 182 fewer staff years in FY 1988 than authorized by the new ceiling.

The FHLBB has indeed had serious personnel problems that are of grave concern to OMB as well as to the Congress. We very much appreciate your attention to these problems.

I thank you for the opportunity to clarify OMB's role in these matters and respectfully request that this letter be included in the printed record.

Sincerely yours,

Carol T. Crawford
Associate Director for
Economics and Government

Enclosure

IDENTICAL LETTER SENT TO HONORABLE JAKE GARN

c: Edwin Gray
President and Chief Operating Officer
Chase Federal Savings Bank

M. Danny Wall
Chairman
Federal Home Loan Bank Board

Enclosure

Federal Home Loan Bank Board and Federal Savings and Loan Insurance Corporation

Full-Time Equivalent Staff Years

Fiscal Year	Bank Board Request	Approved Ceiling (President's Budget)	Actual	Excess of Ceiling over Actual
1982	--	--	1,528	--
1983	1,567	1,555	1,532	23
1984	1,560	1,535	1,467	68
1985	1,544	1,450	1,291	159
1986*	862	862	733	129
1987**	952	952	855	97
1988**	1,252	1,252	1,070	182

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*The original agency request was for 1,634 staff years. OMB approved 1,525 staff years, but after the transfer of the field examination staff in July 1985 the ceiling was effectively reduced to 628. The Bank Board then requested a staff increase to 862 FTEs, which was approved by OMB.

**Reflects Bank Board interim request to increase staff years by 100 FTEs in 1987 and 400 in 1988, from the previous authorized level of 852 for 1987. This was approved by OMB in the Spring of 1987. The "Actual" staff year level in 1988 is based on an estimate through September.

Written Statement of the
Investment Company Institute
Before the Consumer Affairs Subcommittee of
the United States Senate Committee on
Banking, Housing, and Urban Affairs
Concerning the Regulation of Financial Planners

August 2, 1988

The Investment Company Institute* welcomes the opportunity to submit written testimony to this subcommittee as it considers the issues surrounding the regulation of financial planners. The Institute strongly supports the proper regulation of the entire securities industry, including investment advisers and financial planners. We start with the proposition that in the area of financial products and services, regulation is imperative for sound and efficient securities markets and the protection of investors. We therefore have consistently supported adequate funding and staffing for the Securities and Exchange Commission, cooperation between the SEC and state authorities and, where appropriate, systems of self-regulation with SEC oversight.

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* The Institute is the national association of the American investment company industry. Many of the Institute's investment adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 523 associate members which render investment management services exclusively to non-investment company clients. A substantial portion of the total assets managed by registered investment advisers are managed by these Institute members and associate members.

The federal Investment Advisers Act of 1940 and state securities laws establish the existing framework for regulating investment advisers. There is no need to amend the Investment Advisers Act to encompass financial planners since, as has been made clear by the SEC and the North American Securities Administrators Association (NASAA) in their adoption of Release 1092 on October 8, 1987, most financial planners are already subject to the Advisers Act.

In November, 1986, NASAA adopted model investment adviser amendments to the Uniform Securities Act of 1956, the act upon which most states' securities laws are based. Those model amendments provide for a uniform system of state regulation and a coordinated system with the provisions of the federal Investment Advisers Act. The Institute has encouraged those states which currently have no investment adviser laws (of which there are only eight) and which are desirous of passing such legislation, as well as those states which believe their existing investment adviser laws need to be improved, to utilize the NASAA model amendments. Since November, 1986, four states have adopted investment adviser legislation, all of which are based on the NASAA model amendments. There has been no separate financial planner legislation adopted in any state.

Thus, laws and regulations governing financial planners are already in place at both the federal and state level. The major problem appears to be the lack of adequate governmental resources to assure compliance with existing regulatory requirements. For example, we have read with interest the July 25, 1988 NASAA news release concerning financial planner fraud and abuse. It appears that many of the cases included in the report involved activities which are already prohibited under federal law and under most existing state laws. What is lacking is an adequate mechanism to improve compliance with existing requirements.

The Institute has suggested that this problem be addressed by having the National Association of Securities Dealers, Inc. (NASD) inspect investment advisers, including financial planners. We believe that the NASD pilot program of inspecting investment advisers which are members of the NASD or associated with members of the NASD indicates that the NASD is capable of being the inspection-only SRO for investment advisers, including financial planners. In fact, in July, 1988, the Director of the SEC's Division of Investment Management stated before this subcommittee that broadening the authority and responsibility of the NASD would be the most effective near-term approach to the problem.

We greatly appreciate the opportunity to submit our views and would be pleased to furnish any additional information requested.

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